# OFFICIAL TRANSCRIPT OF PROCEEDINGS BEFORE THE POSTAL RATE COMMISSION

In the Matter of: )
)
RATE AND SERVICE CHANGES )
TO IMPLEMENT BASELINE ) Docket No. MC2005-3
NEGOTIATED SERVICE AGREEMENT )
WITH BOOKSPAN )

RECEIVED
2005 DEC -8 A 10: 29
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

VOLUME #5

MATERIAL INCORPORATED INTO THE RECORD

Date: November 7, 2005

Place: Washington, D.C.

Pages: 520 through 587

**HERITAGE REPORTING CORPORATION**
*Official Reporters*
1220 L Street, N.W., Suite 600
Washington, D.C. 20005
(202) 628-4888

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Rate and Service Changes to Implement Baseline Negotiated Service Agreement with

Docket No. MC2005-3

DESIGNATION OF WRITTEN CROSS-EXAMINATION

| Party | Interrogatories |
|---|---|
| **Bookspan** | |
| **Matthias Epp (Bookspan-T-2)** | |
| Office of the Consumer Advocate | PRC/Bookspan-POIR No.3 - Q1 redirected to T2<br>Questions Posed at Hearing Tr. 2/141-154 |
| Postal Rate Commission | PRC/Bookspan-POIR No.3 - Q2b redirected to T2 |
| **United States Postal Service** | |
| **Michael K. Plunkett (USPS-T-1)** | |
| Postal Rate Commission | PRC/USPS-POIR No.3 - Q1, 2a, 2c redirected to T1 |
| **Michelle K. Yorgey (USPS-T-2)** | |
| Office of the Consumer Advocate | OCA/USPS-T2-21a-e<br>PRC/USPS-POIR No.3 - Q3 redirected to T2<br>Questions Posed at Hearings Tr. 2/141-154 |

| Party | Interrogatories |
| --- | --- |
| **Institutional** | |
| Office of the Consumer Advocate | OCA/USPS-T2-22 redirected to USPS |
| Postal Rate Commission | OCA/USPS-T2-23-24 redirected to USPS |

Respectfully submitted,

Steven W. Williams
Secretary

INTERROGATORY RESPONSES
DESIGNATED AS WRITTEN CROSS-EXAMINATION

| Interrogatory | Designating Parties |
|---|---|
| **Bookspan** | |
| **Matthias Epp (Bookspan-T-2)** | |
| PRC/Bookspan-POIR No.3 - Q1 redirected to T2 | OCA |
| PRC/Bookspan-POIR No.3 - Q2b redirected to T2 | PRC |
| Questions Posed at Hearing Tr. 2/141-154 | OCA |
| **United States Postal Service** | |
| **Michael K. Plunkett (USPS-T-1)** | |
| PRC/USPS-POIR No.3 - Q1 redirected to T1 | PRC |
| PRC/USPS-POIR No.3 - Q2a redirected to T1 | PRC |
| PRC/USPS-POIR No.3 - Q2c redirected to T1 | PRC |
| **Michelle K. Yorgey (USPS-T-2)** | |
| OCA/USPS-T2-21a | OCA |
| OCA/USPS-T2-21b | OCA |
| OCA/USPS-T2-21c | OCA |
| OCA/USPS-T2-21d | OCA |
| OCA/USPS-T2-21e | OCA |
| PRC/USPS-POIR No.3 - Q3 redirected to T2 | OCA |
| Questions Posed at Hearings Tr. 2/141-154 | OCA |
| **Institutional** | |
| OCA/USPS-T2-22 redirected to USPS | OCA |
| OCA/USPS-T2-23 redirected to USPS | PRC |
| OCA/USPS-T2-24 redirected to USPS | PRC |

**Bookspan**

**Matthias Epp**
**(Bookspan-T-2)**

RESPONSE OF BOOKSPAN WITNESS EPP TO PRESIDING OFFICER'S INFORMATION REQUEST NO.3

1. At the hearings on October 19, 2005, the Presiding Officer asked witness Yorgey to examine an OCA cross-examination exhibit, and if necessary, provide corrected information. Tr. 2/202-3. Witness Yorgey provided a corrected version of the exhibit, including an explanation of her corrections. Her response includes a further statement regarding the applicability of the exhibit to the purpose for which OCA intended it.

> The OCA exhibit purported to measure the volume response to changes in prices. In order to measure such a response accurately, all things, not just the letter mail mix as represented by the billing determinants, must be held constant. Further information is needed from Bookspan in order to confirm whether witness Epp's estimates cited in the exhibit represent such a scenario of *ceteris paribus.*[1]

Bookspan witness Epp provides a further response, which addresses the issue raised by Yorgey.[2] In his response, he states that, "As Witness Yorgey suggests, the assumptions underlying these letter volume estimates under different scenarios are obviously not the same." After describing the effects of what might be called a cross-elasticity between letters and flats, he goes on to identify several non-price factors that influence letter mail volume. This response indicates that Epp's volume forecasts assume differences between scenarios other than the implementation of the R2005-1 proposed rate increase and/or the implementation of the proposed NSA, as appropriate.

Please provide revised volume estimates that hold all factors other than the effects of Docket No. R2005-1, and/or the effects of the NSA (as appropriate to each scenario) constant. The Postal Service is also directed to revise USPS-T-2 Appendix A to incorporate before and after rates volume forecasts that assume all factors except the implementation of the NSA remain constant.

Response:

The scenario set forth in my response to POIR No. 1, Question 4.a. assumed no rate increases (contrary to what has been recommended in R2005-1), and no NSA. In light of the Commission's decision in R2005-1, that forecast is not valid.

---

[1] Response of United States Postal Service Witness Yorgey to Request of Presiding Officer at Hearings, October 28, 2005.

[2] Response of Witness Epp to Partially Redirected Request of the Presiding Officer at Hearings, October 28, 2005.

RESPONSE OF BOOKSPAN WITNESS EPP TO PRESIDING OFFICER'S INFORMATION REQUEST NO.3

The before and after NSA volume forecasts I provided in my testimony assumed that all factors except *the implementation of the NSA* remain constant. Those scenarios both assume that the increase the Postal Service proposed in R2005-1 would become effective. However, for Bookspan to "hold all factors other than...the effects of the NSA constant" is not the same as assuming that *all factors except postage* remain constant. My forecasts reflect the company's dynamic response to a long term price contract, rather than a static model of a response to a simple change in price.

I have previously attempted to describe Bookspan's dynamic marketing budgeting and planning process. (See my testimony at pp. 5-9, and Tr. at 4/508-510.) Various factors (aside from the applicable postage for a direct mail piece) that are influenced by the existence of this NSA comprise this dynamic response, and affect Bookspan's forecasted mail volume assuming the NSA is implemented. It may aid the Commission's understanding of this issue to offer a few illustrations of how some of these factors could play out to indirectly influence mail volume.

First, an NSA of three years' duration will have a durable favorable effect on Bookspan's postage costs, and thus has greater potential to alter marketing strategy more significantly than an anticipated increase in costs. A discount on postage will push some planned direct mail campaigns, campaigns that would otherwise not get executed, ahead of campaigns *in other media* in the campaign ranking process. Also, with respect to direct mail campaigns that would get executed, the discount will make lists (including lower cost internal lists) that are not currently projected as profitable appear profitable, so these additional lists would be added to these campaigns for execution. Because Bookspan already spends significantly more on planning and executing direct mail

RESPONSE OF BOOKSPAN WITNESS EPP TO PRESIDING OFFICER'S INFORMATION REQUEST NO.3

campaigns (including mailpiece design and production, paper, printing, list costs, and postage) than on other media (see OCA/Bookspan-T2-11(b) which is filed under seal), the existence of the NSA is likely to yield a significant increase in Bookspan's mail volumes in the first year following implementation of the NSA.

Second, the anticipated membership growth that would result from a sustained increase in direct mail would influence our ability to negotiate some of our agreements on the basis of increasing volumes. If the cost of these other agreements (e.g., printing and letter shop costs) go down, the funds that would otherwise have been applied to those costs would be available for new member acquisition. Over time, that would mean more mail volume.

Third, the existence of an NSA of three years' duration is likely to motivate the testing of campaigns during the first year with different mailpieces that are less costly to produce (e.g., solicit using a catalog of fewer pages or lower quality paper). If the results of these tests are favorable (in terms of response rate), these less costly mailpieces gradually could be introduced more widely, the budget savings could be re-allocated, and, again, generate more mail volume in later months and years.

RESPONSE OF BOOKSPAN WITNESS EPP TO PRESIDING OFFICER'S INFORMATION REQUEST NO.3

2.b. Do Bookspan witness Epp's volume forecasts include Standard Regular and Standard ECR, or just Standard Regular?

Response:

My volume forecasts do not distinguish between Standard Regular and Standard ECR.

RESPONSE OF BOOKSPAN WITNESS EPP TO REQUEST OF PRESIDING OFFICER AT HEARINGS

During cross-examination of witness Yorgey on October 19, 2005, counsel for the OCA asked a series of questions concerned a cross-examination exhibit that she presented to the witness. Tr. 2/141-154. Subsequently, the Presiding Officer requested that the witness compare the exhibit with source data, examine the OCA's examples for accuracy, and, if needed, provide correct information with an explanation of how it was developed. Tr. 2/203.

**Response:**

In Witness Yorgey's response filed today, she indicates that "[i]n order to measure such a response accurately, all things, not just the letter mail mix as represented by the billing determinants, must be held constant," and directs Bookspan to provide further information to indicate whether my estimates "represent such a scenario of *ceteris paribus*." In this response, I address that point.

As Witness Yorgey suggests, the assumptions underlying these letter volume estimates under different scenarios are obviously not the same. This point is most simply illustrated by the simple fact that my estimated flat volumes also change. While a rate increase affects both letters and flats, the NSA discount only applies to letters, so in addition to the lower postage for letters (which by itself will help mail volume) flats now become more costly in relative terms which will lead to a shift from flats to letters. This shift would not be captured in any "postage-mail volume elasticity" if it existed. As a result, the increase in letter volume with an NSA discount will be higher than a corresponding decrease in letter volume when rates go up. (We assume rates go up for both formats, thus there is no relative price change between them)

As I understand the point of the OCA's exhibit, the OCA incorrectly assumes that there exists a direct relationship, and therefore a quantifiable elasticity of mail volume in relation to postage. As I explained in my testimony, and during the hearing, postage paid

RESPONSE OF BOOKSPAN WITNESS EPP TO REQUEST OF PRESIDING OFFICER AT HEARINGS

for letters is only one of the factors that drive letter mail volume. It is an important factor, and that is why we have negotiated this NSA, but it is still only one. Other factors include (but are not necessarily limited to) the cost of books and paper, royalty rates, list costs, rental terms, other media costs, and marketing goals.

The existence of the NSA itself factors into marketing budgeting and planning. To reap the benefits of the NSA will requires changes in our marketing mix, so I would plan to shift money from other channels in order to achieve the commitment goals set by the NSA. Also, as a result of obtaining the NSA, corporate strategy may direct higher marketing goals in terms of new member growth, which may result in an increase in the overall marketing budget.

**United States Postal Service**

**Michael K. Plunkett**
**(USPS-T-1)**

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO PRESIDING OFFICER'S INFORMATION REQUEST NO. 3

1. At the hearings on October 19, 2005, the Presiding Officer asked witness Yorgey to examine an OCA cross-examination exhibit, and if necessary, provide corrected information. Tr. 2/202-3. Witness Yorgey provided a corrected version of the exhibit, including an explanation of her corrections. Her response includes a further statement regarding the applicability of the exhibit to the purpose for which OCA intended it.

> The OCA exhibit purported to measure the volume response to changes in prices. In order to measure such a response accurately, all things, not just the letter mail mix as represented by the billing determinants, must be held constant. Further information is needed from Bookspan in order to confirm whether witness Epp's estimates cited in the exhibit represent such a scenario of *ceteris paribus.*[1]

Bookspan witness Epp provides a further response, which addresses the issue raised by Yorgey.[2] In his response, he states that, "As Witness Yorgey suggests, the assumptions underlying these letter volume estimates under different scenarios are obviously not the same." After describing the effects of what might be called a cross-elasticity between letters and flats, he goes on to identify several non-price factors that influence letter mail volume. This response indicates that Epp's volume forecasts assume differences between scenarios other than the implementation of the R2005-1 proposed rate increase and/or the implementation of the proposed NSA, as appropriate.

Please provide revised volume estimates that hold all factors other than the effects of Docket No. R2005-1, and/or the effects of the NSA (as appropriate to each scenario) constant. The Postal Service is also directed to revise USPS-T-2 Appendix A to incorporate before and after rates volume forecasts that assume all factors except the implementation of the NSA remain constant.

**RESPONSE:**

Please refer first to the response of witness Epp to this question.

I would add form the perspective of the Postal Service that the OCA's interrogatories and cross-examination during the hearing suggest a theory that the

[1] Response of United States Postal Service Witness Yorgey to Request of Presiding Officer at Hearings, October 28, 2005.

[2] Response of Witness Epp to Partially Redirected Request of the Presiding Officer at Hearings, October 28, 2005.

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO PRESIDING OFFICER'S INFORMATION REQUEST NO. 3

implementation of the NSA is purely a price effect, and that as such, this price effect has a direct relationship with mail volumes. The OCA's exhibit incorrectly assumes that there exists a direct relationship, and therefore a quantifiable single firm elasticity of mail volume in relation to the price of postage. The information Mr. Epp provides in response to this question illustrates that the existence and duration of the contract will motivate other changes in the company's behavior. These changes would not be reflected in a static model of price elasticity. Because the various factors he describes change the overall budget for direct mail and influence other changes in behavior, one cannot meaningfully quantify Bookspan's elasticity of mail volume in direct relation to postage. To require Bookspan to consider only a short-term price effect, and ignore the likely impact of the existence of an NSA of three years' duration on Bookspan's marketing budgeting and planning would not yield volume forecasts that would be meaningful for purposes of the consideration of the financial impact of this NSA on the Postal Service.

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO PRESIDING OFFICER'S INFORMATION REQUEST NO. 3

2. The proposed DMCS language included in the Request defines eligible mail in terms that do not distinguish between Standard Regular and Standard ECR.

620.1 Eligible Standard Mail

620.11 Bookspan

Eligible Standard Mail under this section is defined as letter shaped pieces sent by Bookspan for the purpose of soliciting book club membership of persons who are not current subscribers to the book club or clubs Bookspan is promoting in the mailing or to book club members whose membership is expiring. Such pieces may be sent by Bookspan, by entities in which Bookspan holds controlling shares, or by their vendors on their behalf. Such letters may include promotions of Bookspan's strategic business alliances.

620.12 Other Mailers

Functionally equivalent NSAs, involving declining block rates for Standard Mail letter solicitations for book or analogous club memberships, may be entered into with other customers demonstrating a similar or greater multiplier effect, as specified by the Postal Service, and implemented pursuant to proceedings under Chapter 36 of Title 39, of the United States Code.

This contrasts with statements made by witness Plunkett during cross-examination.

Q And does your reference to standard mail in line five [of page four of your testimony] include reference to both standard regular and standard ACR [sic]?

A In line five I did not make a distinction between the two. **Of course our agreement with Bookspan is standard mail regular.** But my statement was more general in nature and I was discussing standard mail.

Q Bookspan does send mail at standard ECR, does it not?

A That's correct, they do.

Tr. 2/293-94 (emphasis added).

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO PRESIDING OFFICER'S INFORMATION REQUEST NO. 3

A similar discussion ensued regarding the definition of functional equivalence.

Q I notice that the proposed EMCS [sic] language refers to standard mail letter solicitations. In your answer to interrogatory eight, you stated that you would expect any mailer qualifying as functionally equivalent would be producing standard mail regular letters for the purpose of acquiring customers and you made a similar response to ValPak one.

**I don't see the word 'regular' in the DMCS section. Is it your intent to limit functionally equivalent NSAs to standard regular solicitations?**

....

Q Okay.

**As a policy witness here, would the Postal Service oppose or support inserting the word 'regular' in this language?**

A I'd have to take that up with the people who worked in crafting this. I'm at a loss to think of a reason why we would object strongly. I haven't really given it much thought.

Tr. 2/325-26 (emphasis added).

a. The proponents are requested to confer and jointly clarify to the Commission their understanding of the intent of the terms to which they agreed. Did they intend to restrict eligible mail to Standard Regular letters, or did they intend for Standard ECR letters to also be eligible?

b. Do Bookspan witness Epp's volume forecasts include Standard Regular and Standard ECR, or just Standard Regular?

c. If necessary, please provide a revised version of USPS-T-2 Appendix A to reflect the response to part a.

**RESPONSE:**

a. It was and remains the intention of the proponents that eligible mail under the NSA include both Standard Mail Regular and Standard Mail ECR.

b. Bookspan will respond.

c. USPS-T-2 Appendix A reflects both subclasses; no revision is necessary.

**United States Postal Service**

**Michelle K. Yorgey**
**(USPS-T-2)**

RESPONSE OF THE UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE CONSUMER ADVOCATE REDIRECTED FROM WITNESS YORGEY

OCA/USPS-T2-21. Please refer to your revised response to interrogatory OCA/USPS-T2-11.a. - e.

a. You cite "Audit Report – International Customized Mail Agreements (Report Number MS-AR-05-001) (August 16, 2005)" for the ICM program in FY 2003. Please supply a copy of this report.
b. For FY 2003, what were the total costs of the ICM program?
c. For FY 2003, what were the total revenues of the ICM program?
d. Please supply all other audit reports for International Customized Mail agreements prepared by the Inspector General, for 1996 to date.
e. Please supply any other types of reports for International Customized Mail Agreements, besides audit reports, prepared by the Inspector General, for 1996 to date.

RESPONSE:

a.-e. For the report and supporting data, and other reports prepared by the Inspector General, please see the Inspector General's website at www.uspsoig.gov.

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS YORGEY
TO PRESIDING OFFICER'S INFORMATION REQUEST NO. 3

3. Please identify the version of the Postal Service's financial analysis (originally filed as USPS-T-2 Appendix A) that reflects the rates included in the Commission's R2005-1 Opinion and Recommended Decision, or provide one if necessary.

**RESPONSE:**

Please see the attachments.

# Bookspan - Response to POIR3

| Negotiated Service Agreement<br>Appendix A, page 1 | | FY 2006 | FY 2007 | FY 2008 |
|---|---|---|---|---|
| **(1)** | Inflation cost adjustment factor | 4.0% | 4.0% | 4.0% |
| **(2)** | Conversion of Standard Mail Flats to Standard Mail Letters | 63.0% | 63.3% | 62.5% |
| **(3)** | Contingency Factor | 1.00 | | |

(1) Docket No. MC2004-4/USPS-T-1, pg 13
(2) Docket No. MC2005-3, Bookspan T-2, p11
(3) Contingency provision of zero percent, Docket No.R2005-1, USPS-T-6, p. 18.

# Bookspan - Response to POIR3

Negotiated Service Agreement
Appendix A, page 2

| | FY 2002 | FY 2003 | FY 2004 | FY 2006 | FY 2007 | FY 2008 |
|---|---|---|---|---|---|---|
| **Volume calculations (1)** | | | | **Forecast Volumes (2)** | | |
| **Before Rates (BR)** | | | | | | |
| New Membership Std letter-size | 84,694,802 | 82,991,923 | 94,014,756 | 78,000,000 | 75,000,000 | 75,000,000 |
| New Membership Std Flat-size | 215,324,921 | 196,631,597 | 164,378,427 | 137,000,000 | 129,000,000 | 130,000,000 |
| **Total** | **300,019,723** | **279,623,520** | **258,393,183** | **215,000,000** | **204,000,000** | **205,000,000** |
| **After Rates (AR)** | | | | | | |
| New Membership Std letter-size | | | | 105,000,000 | 105,000,000 | 107,000,000 |
| New Membership Std Flat-size | | | | 120,000,000 | 110,000,000 | 110,000,000 |
| **Total** | | | | **225,000,000** | **215,000,000** | **217,000,000** |

(1) CBCIS - FY 2002, 2003, 2004 volumes
(2) Docket No. MC2005-3, Bookspan T-2, p11

539

# Bookspan - Response to POIR3
Negotiated Service Agreement
Appendix A, page 3

***Standard Mail Regular Letter-size Revenue per piece***

| | Bookspan average | | | | USPS TYAR Totals | | | |
|---|---|---|---|---|---|---|---|---|
| **Mail Category** | **Revenue per piece (1)** | **Volume (2)** | **Revenue (3)** | | **Revenue per piece (5)** | **Volume (6)** | **Revenue (7)** | |
| Nonauto Basic | 0.274 | 1,518,805 | $ 416,338 | | $ 0.276 | 801,064,649 | $ 221,408,063 | |
| Nonauto 3/5-Digit | 0.245 | 58,859 | $ 14,413 | | $ 0.249 | 697,778,977 | $ 174,021,436 | |
| Auto Mixed AADC | 0.228 | 7,078,780 | $ 1,613,417 | | $ 0.229 | 2,225,648,221 | $ 510,350,945 | |
| Auto AADC | 0.216 | 12,572,357 | $ 2,709,992 | | $ 0.218 | 2,506,836,948 | $ 545,899,318 | |
| Auto 3-digit | 0.193 | 60,973,641 | $ 11,752,555 | | $ 0.199 | 18,036,591,744 | $ 3,592,907,632 | |
| Auto 5-digit | 0.176 | 4,830,798 | $ 849,053 | | $ 0.179 | 19,268,811,720 | $ 3,454,871,315 | |
| **Total** | | **87,033,240** | **$ 17,355,768** | | | **43,536,732,259** | **$ 8,499,458,709** | |
| **Revenue per piece** | | | **$ 0.199** | | | | **$ 0.195** | |

**Standard Mail ECR Letter-size Revenue per piece**

| **Mail Category** | **Revenue per piece** | **Volume** | **Revenue** | | **Revenue per piece** | **Volume** | **Revenue** | |
|---|---|---|---|---|---|---|---|---|
| Nonauto Basic Letters | 0.180 | 5,575,871 | 1,003,174 | | $ 0.182 | 2,204,590,228 | $ 400,863,057 | |
| Auto Basic Letters | 0.156 | 1,405,645 | 219,916 | | $ 0.158 | 2,012,745,225 | $ 318,400,916 | |
| **Total** | | **6,981,516** | **1,223,090** | | | **4,217,335,453** | **$ 719,263,973** | |
| **Revenue per piece** | | | **$ 0.175** | | | | **$ 0.171** | |
| **Average Revenue per piece** | | | **$ 0.198** | (4) | | | **$ 0.193** | (8) |

(1) Based on R2005 rates (see Attachment 2 for calculations)
(2) CBCIS, Bookspan FY2004 volume
(3) (1)*(2)
(4) Bookspan (Standard Mail Regular Revenue + Standard Mail ECR Revenue) / (Standard Mail Regular Total Volume + Standard Mail ECR Total Volume)
(5) (7)/(6)
(6) Docket No. R2005-1, PRC-LR-12
(7) Docket No. R2005-1, PRC-LR-12
(8) USPS (Standard Mail Regular Revenue + Standard Mail ECR Revenue) / (Standard Mail Regular Total Volume + Standard Mail ECR Total Volume)

# Bookspan - Response to POIR3
Negotiated Service Agreement
Appendix A, page 4

**Standard Regular Unit Cost**

| | USPS | | | Bookspan | | | |
|---|---|---|---|---|---|---|---|
| | TYAR 2006 Total Unit Cost (Dollars) (1) | TYAR 2006 Mail Volume (Pieces) (2) | TYAR 2006 Mail Volume (Percent) (3) | TYAR 2006 Total Unit Cost (Dollars) (4) | FY 2004 Mail Volume (Pieces) (6) | FY 2004 Mail Volume (Percent) (7) | Company Avg. Letter Cost w/Contingency (Dollars) (8) |
| **LETTERS** | | | | | | | |
| Nonauto Basic | 0.235 | 809,733,939 | 1.9% | 0.235 | 1,518,805 | 1.7% | |
| Nonauto 3/5-Digit | 0.220 | 697,778,977 | 1.6% | 0.220 | 58,859 | 0.1% | |
| Auto Mixed AADC | 0.094 | 2,217,147,820 | 5.1% | 0.094 | 7,078,780 | 8.1% | |
| Auto AADC | 0.085 | 2,496,325,308 | 5.7% | 0.085 | 12,572,357 | 14.4% | |
| Auto 3-digit | 0.081 | 17,989,964,663 | 41.4% | 0.081 | 60,973,641 | 70.1% | |
| Auto 5-digit | 0.070 | 19,265,167,056 | 44.3% | 0.070 | 4,830,798 | 5.6% | |
| | | | | (5) | | | |
| **Total/average** | **0.082** | **43,476,117,763** | **100.0%** | **0.085** | **87,033,240** | **100.0%** | **$ 0.085** |

**Standard ECR Unit Cost**

| | TYAR 2006 Total Unit Cost (Dollars) (9) | TYAR 2006 Mail Volume (Pieces) (10) | TYAR 2006 Mail Volume (Percent) (11) | TYAR 2006 Total Unit Cost (Dollars) (12) | FY 2004 Mail Volume (Pieces) (14) | FY 2004 Mail Volume (Percent) (15) | Company Avg. Letter Cost w/Contingency (Dollars) (16) |
|---|---|---|---|---|---|---|---|
| **LETTERS** | | | | | | | |
| Nonauto Basic Letters | 0.094 | 2,204,590,228 | 52.3% | 0.094 | 5,575,871 | 79.9% | |
| Auto Basic Letters | 0.046 | 2,008,138,417 | 47.7% | 0.046 | 1,405,645 | 20.1% | |
| | | | | (13) | | | |
| **Total/Average** | **0.071** | **4,212,728,645** | **100.0%** | **0.084** | **6,981,516** | **100.0%** | **$ 0.084** |

**Bookspan Average Cost per piece** **$ 0.085** (17)

(1) **Docket No. R2005-1 (USPS-LR-K-48 as revised 05/20/05, USPS-LR-K-67, USPS-LR-K-119) x 1.001**
(2) **Docket No. R2005-1 (USPS-T-7, Attachment A, pg. 7)**
(3) Each row in **(2)** divided by total in **(2)**
(4) **(1)**
(5) **(4)** x **(7)** Bookspan weighted average
(6) CBCIS, Bookspan FY2004 volume (Appendix A, pg. 3)
(7) Each row in **(6)** divided by total in **(6)**
(8) Total Unit Cost **(5)** x Contingency Factor Assumption (Appendix A, pg. 1, **(3)**)
(9) **Docket No. R2005-1 (USPS-LR-K-67, USPS-LR-K-84, USPS-LR-K-119) x 1.001**
(10) **Docket No. R2005-1 (USPS-T-7, Attachment A, pg. 7)**
(11) Each row in **(10)** divided by total in **(10)**
(12) **(9)**
(13) **(12)** x **(15)** Bookspan weighted average
(14) CBCIS, Bookspan FY2004 volume (Appendix A, pg. 3)
(15) Each row in **(14)** divided by total in **(14)**
(16) Total Unit Cost **(13)** x Contingency Factor Assumption (Appendix A, pg. 1, **(3)**)
(17) **((8)x(6) + (16)x(14)) / ((6) + (14))**

## Bookspan - Response to POIR3
Negotiated Service Agreement
Appendix A, page 5

**Standard Mail Regular Non-letter Revenue per piece**

| | Bookspan average | | | | USPS TYAR Totals | | | |
|---|---|---|---|---|---|---|---|---|
| **Mail Category** | **Revenue per piece (1)** | **Volume (2)** | **Revenue (3)** | | **Revenue per piece (5)** | **Volume (6)** | **Revenue (7)** | |
| Nonauto Basic | $ 0.362 | 29,186 | 10,564 | | $ 0.439 | 295,780,664 | 129,880,374 | |
| Nonauto 3/5 Digit | $ 0.281 | 1,367,428 | 383,885 | | $ 0.348 | 563,700,887 | 196,423,222 | |
| Auto Basic | $ 0.311 | 167,112 | 51,897 | | $ 0.404 | 395,702,206 | 159,686,570 | |
| Auto 3/5 Digit | $ 0.252 | 97,096,345 | 24,460,404 | | $ 0.305 | 11,168,522,297 | 3,406,054,465 | |
| **Total** | | **98,660,071** | **$ 24,906,750** | | | **12,423,706,054** | **$ 3,892,044,631** | |
| **Revenue per piece** | | | **$ 0.252** | | | | **$ 0.313** | |

**Standard Mail ECR Non-letter Revenue per piece**

| **Mail Category** | **Revenue per piece** | **Volume** | **Revenue** | | **Revenue per piece** | **Volume** | **Revenue** | |
|---|---|---|---|---|---|---|---|---|
| Basic Non-letter | $ 0.178 | 65,718,356 | 11,708,467 | | $ 0.208 | 12,237,543,949 | 2,547,453,523 | |
| **Total** | | **65,718,356** | **$ 11,708,467** | | | **12,237,543,949** | **$ 2,547,453,523** | |
| **Revenue per piece** | | | **$ 0.178** | | | | **$ 0.208** | |
| **Average Revenue per piece** | | | **$ 0.223** | (4) | | | **$ 0.261** | (8) |

(1) Based on R2005 rates (see Attachment 2 for calculations)
(2) CBCIS, Bookspan FY2004 volume
(3) (1)*(2)
(4) Bookspan (Standard Mail Regular Revenue + Standard Mail ECR Revenue) / (Standard Mail Regular Total Volume + Standard Mail ECR Total Volume)
(5) (7)/(6)
(6) Docket No. R2005-1, PRC-LR-12
(7) Docket No. R2005-1, PRC-LR-12
(8) USPS (Standard Mail Regular Revenue + Standard Mail ECR Revenue) / (Standard Mail Regular Total Volume + Standard Mail ECR Total Volume)

## Bookspan - Response to POIR3
Negotiated Service Agreement
Appendix A, page 6

**Standard Regular Unit Cost**

| | USPS | | | Bookspan | | | |
|---|---|---|---|---|---|---|---|
| | TYAR 2006 Total Unit Cost (Dollars) (1) | TYAR 2006 Mail Volume (Pieces) (2) | TYAR 2006 Mail Volume (Percent) (3) | TYAR 2006 Total Unit Cost (Dollars) (4) | FY 2004 Mail Volume (Pieces) (6) | FY 2004 Mail Volume (Percent) (7) | Company Avg. Letter Cost w/Contingency (Dollars) (8) |
| **NON-LETTERS** | | | | | | | |
| Nonauto Basic | 0.351 | 443,471,958.026 | 3.4% | 0.351 | 29,186 | 0.0% | |
| Nonauto 3/5 Digit | 0.265 | 925,540,123.464 | 7.1% | 0.265 | 1,367,428 | 1.4% | |
| Auto Basic | 0.347 | 414,714,246.537 | 3.2% | 0.347 | 167,112 | 0.2% | |
| Auto 3/5 Digit | 0.261 | 11,218,794,042.215 | 86.3% | 0.261 | 97,096,345 | 98.4% | |
| | | | | (5) | | | |
| **Total/average** | **0.267** | **13,002,520,370** | **100.0%** | **0.261** | **98,660,071** | **100.0%** | **$ 0.261** |

**Standard ECR Unit Cost**

| | TYAR 2006 Total Unit Cost (Dollars) (9) | TYAR 2006 Mail Volume (Pieces) (10) | TYAR 2006 Mail Volume (Percent) (11) | TYAR 2006 Total Unit Cost (Dollars) (12) | FY 2004 Mail Volume (Pieces) (14) | FY 2004 Mail Volume (Percent) (15) | Company Avg. Letter Cost w/Contingency (Dollars) (16) |
|---|---|---|---|---|---|---|---|
| **NON-LETTERS** | | | | | | | |
| Basic Non-Letters | 0.098 | 12,224,335,151 | 100.0% | 0.098 | 65,718,356 | 100.0% | |
| | | | | (13) | | | |
| **Total/Average** | **0.098** | **12,224,335,151** | **100.0%** | **0.098** | **65,718,356** | **100.0%** | **$ 0.098** |

| | | |
|---|---|---|
| **Bookspan Average Cost per piece** | **$ 0.196** | (17) |

(1) **Docket No. R2005-1 (USPS-LR-K-58, USPS-LR-K-67, USPS-LR-K-119) x 1.001**
(2) **Docket No. R2005-1 (USPS-T-7, Attachment A, pg. 7)**
(3) Each row in **(2)** divided by total in **(2)**
(4) **(1)**
(5) **(4) x (6)** Bookspan weighted average
(6) CBCIS, Bookspan FY2004 volume (Appendix A, pg. 5)
(7) Each row in **(6)** divided by total in **(6)**
(8) Total Unit Cost **(5)** x Contingency Factor Assumption (Appendix A, pg. 1, **(3)**)
(9) **Docket No. R2005-1 (USPS-LR-K-67, USPS-LR-K-84, USPS-LR-K-119) x 1.001**
(10) **Docket No. R2005-1 (USPS-T-7, Attachment A, pg. 7)**
(11) Each row in **(10)** divided by total in **(10)**
(12) **(9)**
(13) **(12) x (15)** Bookspan weighted average
(14) CBCIS, Bookspan FY2004 volume (Appendix A, pg. 5)
(15) Each row in **(14)** divided by total in **(14)**
(16) Total Unit Cost **(13)** x Contingency Factor Assumption (Appendix A, pg. 1, **(3)**)
(17) **((8)x(6) + (16)x(14)) / ((6) + (14))**

# Bookspan - Response to POIR3
**Negotiated Service Agreement**
**Appendix A, page 7**

## Agreement Structure

| FY2006 | | | FY2007 | | | FY2008 | | |
|---|---|---|---|---|---|---|---|---|
| Threshold | | Discount | Threshold | | Discount | Threshold | | Discount |
| 87,000,001 | 120,000,000 | $ 0.020 | 85,000,001 | 110,000,000 | $ 0.020 | 94,000,001 | 100,000,000 | $ 0.010 |
| 120,000,001 | 150,000,000 | $ 0.030 | 110,000,001 | 150,000,000 | $ 0.030 | 100,000,001 | 120,000,000 | $ 0.020 |
| | | | | | | 120,000,001 | 150,000,000 | $ 0.030 |

**Discount on volume above threshold**

| | | FY2006 | FY2007 | FY2008 |
|---|---|---|---|---|
| (1) | Before Rates Forecast | 78,000,000 | 75,000,000 | 75,000,000 |
| (2) | After Rates Forecast | 105,000,000 | 105,000,000 | 107,000,000 |
| (3) | Discount in first tier | $ 360,000 | $ 400,000 | $ 60,000 |
| | Discount in second tier | $ - | $ - | $ 140,000 |
| | Discount in third tier | | $ - | $ - |
| (4) | **Discount Earned** | **$ 360,000** | **$ 400,000** | **$ 200,000** |

**Exposure on volume above threshold**

| | | FY2006 | FY2007 | FY2008 |
|---|---|---|---|---|
| (5) | Threshold | 87,000,001 | 85,000,001 | 94,000,001 |
| (6) | Before Rates Forecast | 78,000,000 | 75,000,000 | 75,000,000 |
| (7) | Exposed Pieces | - | - | - |
| (8) | After Rates Forecast | 105,000,000 | 105,000,000 | 107,000,000 |
| (9) | Discount Exposure in first tier | $ - | $ - | $ - |
| | Discount Exposure in second tier | $ - | $ - | $ - |
| | Discount Exposure in third tier | | | $ - |
| (10) | **Total Exposure** | **$ -** | **$ -** | **$ -** |

(1) Before Rates Total Volume (Appendix A, pg. 2)
(2) After Rates Total Volume (Appendix A, pg. 2)
(3) Discount Earned per discount tier based on rate chart above.
(4) Sum of discounts earned in first tier to fifth tier
(5) Agreement Structure Beginning Threshold
(6) (1)
(7) If the Before Rates Forecast volume (6) is greater than the Threshold volume (5), then the total pieces represent the volume on which Discount Exposure occurs
(8) (2)
(9) If the Before Rates Forecast volume (6) is greater than the Threshold volume (5), then the Discount Exposure represents the discount X the volume per discount tier.
(10) Sum of Exposure in first tier to third tier

# Bookspan - Response to POIR3

| Negotiated Service Agreement<br>Appendix A, page 8 | FY2006 | (7)<br>FY2007 | (8)<br>FY2008 |
|---|---|---|---|
| **Standard Mail Letters** | | | |
| (1) Standard letters Revenue per Piece | 0.198 | 0.198 | 0.198 |
| (2) Standard letters Cost per Piece | 0.085 | 0.088 | 0.092 |
| (3) Standard letters Contribution per Piece | 0.113 | 0.109 | 0.106 |
| **Standard Mail Non-letters** | | | |
| (4) Standard Non-letter Revenue per Piece | 0.223 | 0.223 | 0.223 |
| (5) Standard Non-letter Cost per Piece | 0.196 | 0.204 | 0.212 |
| (6) Standard Non-letter Contribution per Piece | 0.027 | 0.019 | 0.011 |

(1) Average Revenue per Piece (Appendix A, pg. 3, (4))
(2) Average Cost per Piece (Appendix A, pg. 4, (17))
(3) (1) - (2)
(4) Average Revenue per Piece (Appendix A, pg. 5, (4))
(5) Average Cost per Piece (Appendix A, pg. 6, (17))
(6) (4) - (5)
(7) Year 1 * Inflation cost adjustment factor Year 2 (Appendix A, pg. 1, (1))
(8) Year 2 * Inflation cost adjustment factor Year 3 (Appendix A, pg. 1, (1))

# Bookspan - Response to POIR3

**Negotiated Service Agreement**
**Appendix A, page 9**

| | | FY2006 | FY2007 | FY2008 | Total |
|---|---|---|---|---|---|
| (1) | Contribution from new Standard letter mail | $ 1,126,683 | $ 1,201,975 | $ 1,268,839 | **3,597,497** |
| (2) | Contribution from Standard non-letter mail converted to Standard letter mail | $ 1,459,597 | $ 1,715,669 | $ 1,898,312 | **5,073,578** |
| (3) | **Total New Contribution** | $ 2,586,281 | $ 2,917,643 | $ 3,167,151 | **8,671,075** |
| (4) | **Total Discount Exposure** | $ - | $ - | $ - | **-** |
| (5) | **Total Incremental Discounts** | $ 360,000 | $ 400,000 | $ 200,000 | **960,000** |
| (6) | **Total USPS Value** | **$ 2,226,281** | **$ 2,517,643** | **$ 2,967,151** | **$ 7,711,075** |

(1) (Assumption (2), (Appendix A, pg. 1)) X (Volume Before Discount (Appendix A, pg. 2) - Volume After Discount (Appendix A, pg. 2)) X (Contribution Standard letter mail (3), (Appendix A, pg. 8) - Contribution Standard non-letter mail (6),(Appendix A, pg. 8)
(2) 1minus Assumption (2), (Appendix A, pg. 1) X (Volume After Discount (Appendix A, pg. 2) - Volume After Discount (Appendix A, pg. 2) X Contribution Standard letter mail (Appendix A, pg. 8)
(3) Sum of (1) + (2)
(4) Total Discount Exposure (10)(Appendix A, pg. 7)
(5) Discount Earned (4) (Appendix A, pg. 7)
(6) (3) - (4) - (5)

**Response to POIR 3, Attachment 2, p. 1 of 2**
**Standard Mail Regular Subclass**
**Bookspan MAIL CATEGORIES**

| | 2004 Revenue | 2004 Rev/pc | 2004 Pieces | % Change | R2005 Rev/pc | R2005 Revenue |
|---|---|---|---|---|---|---|
| **Non-Auto Basic Letters** | **398,179** | **0.262** | **1,518,805** | 4.6% | **0.274** | **416,337.76** |
| No Destination Entry | 270,344 | 0.270 | 1,000,573 | 4.4% | 0.282 | 282,161.59 |
| BMC Destination Entry | 100,420 | 0.248 | 405,402 | 5.0% | 0.260 | 105,404.52 |
| SCF Destination Entry | 27,415 | 0.243 | 112,830 | 4.9% | 0.255 | 28,771.65 |
| **Non-Auto 3/5-digit Letters** | **13,882** | **0.236** | **58,859** | 3.8% | **0.245** | **14,413.09** |
| No Destination Entry | 5,820 | 0.251 | 23,224 | 4.2% | 0.261 | 6,061.46 |
| BMC Destination Entry | 610 | 0.234 | 2,607 | 2.2% | 0.239 | 623.07 |
| SCF Destination Entry | 7,452 | 0.226 | 33,028 | 3.7% | 0.234 | 7,728.55 |
| **Auto Mixed AADC Letters** | **1,529,430** | **0.216** | **7,078,780** | 5.5% | **0.228** | 1,613,417.39 |
| No Destination Entry | 1,333,403 | 0.219 | 6,088,744 | 5.5% | 0.231 | 1,406,499.86 |
| BMC Destination Entry | 196,027 | 0.198 | 990,036 | 5.6% | 0.209 | 206,917.52 |
| **Auto AADC Letters** | **2,575,943** | **0.205** | **12,572,357** | 5.2% | **0.216** | 2,709,991.77 |
| No Destination Entry | 1,764,862 | 0.212 | 8,324,819 | 5.2% | 0.223 | 1,856,434.64 |
| BMC Destination Entry | 803,715 | 0.191 | 4,207,936 | 5.2% | 0.201 | 845,795.14 |
| SCF Destination Entry | 7,366 | 0.186 | 39,602 | 5.4% | 0.196 | 7,761.99 |
| **Auto 3-digit Letters** | **11,138,540** | **0.183** | **60,973,641** | 5.5% | **0.193** | 11,752,554.73 |
| No Destination Entry | 865,452 | 0.203 | 4,263,380 | 5.4% | 0.214 | 912,363.32 |
| BMC Destination Entry | 8,567,562 | 0.182 | 47,074,520 | 5.5% | 0.192 | 9,038,307.84 |
| SCF Destination Entry | 1,705,526 | 0.177 | 9,635,741 | 5.6% | 0.187 | 1,801,883.57 |
| **Auto 5-digit Letters** | **805,554** | **0.167** | **4,830,798** | 5.4% | **0.176** | 849,053.42 |
| No Destination Entry | 4,198 | 0.190 | 22,095 | 5.3% | 0.200 | 4,419.00 |
| BMC Destination Entry | 430,234 | 0.169 | 2,545,761 | 5.3% | 0.178 | 453,145.46 |
| SCF Destination Entry | 371,122 | 0.164 | 2,262,942 | 5.5% | 0.173 | 391,488.97 |
| | 16,461,528 | | 87,033,240 | | | 17,355,768 |
| **Standard Mail Enhanced Carrier Route Subclass** | | | | | | |
| **Nonauto Basic Letters** | **952,919** | **0.171** | **5,575,871** | 5.3% | **0.180** | 1,003,174.28 |
| No Destination Entry | 13,906 | 0.194 | 71,681 | 5.2% | 0.204 | 14,622.92 |
| BMC Destination Entry | 496,054 | 0.173 | 2,867,364 | 5.2% | 0.182 | 521,860.25 |
| SCF Destination Entry | 442,228 | 0.168 | 2,632,311 | 5.4% | 0.177 | 465,919.05 |
| DDU Destination Entry | 731 | 0.162 | 4,515 | 5.6% | 0.171 | 772.07 |
| **Auto Basic Letters** | **208,620** | **0.148** | **1,405,645** | 5.4% | **0.156** | 219,915.80 |
| No Destination Entry | 8,719 | 0.171 | 50,986 | 5.3% | 0.180 | 9,177.48 |
| BMC Destination Entry | 104,265 | 0.150 | 695,098 | 5.3% | 0.158 | 109,825.48 |
| SCF Destination Entry | 95,636 | 0.145 | 659,561 | 5.5% | 0.153 | 100,912.83 |
| | 1,161,539 | | 6,981,516 | | | 1,223,090 |
| Source: CBCIS revenue and volume, Bookspan FY2004 | 17,623,067 | | 94,014,756 | | | 18,578,858 |
| | | **0.187** | | 5.4% | **0.198** | |

Response to POIR 3, Attachment 2, page 2 of 2
Standard Mail Regular Subclass
Bookspan Mail Categories

| MAIL CATEGORY | Revenue | Rev/pc | Pieces | % Change | R2005 Rev/pc | Revenue |
|---|---|---|---|---|---|---|
| **Basic Nonletters (piece-rated)** | **10,917** | **0.374** | **29,186** | **-3.23%** | **0.362** | **10,564.49** |
| No Destination Entry | 10,425 | 0.375 | 27,821 | -3.13% | 0.363 | 10,099.02 |
| BMC Destination Entry | 492 | 0.360 | 1,365 | -5.38% | 0.341 | 465.47 |
| **3/5-digit Nonletters (piece-rated)** | **395,959** | **0.290** | **1,367,428** | **-3.05%** | **0.281** | **383,885.48** |
| No Destination Entry | 21,383 | 0.299 | 71,446 | 1.57% | 0.304 | 21,719.58 |
| BMC Destination Entry | 172,137 | 0.271 | 635,777 | 4.15% | 0.282 | 179,289.11 |
| SCF Destination Entry | 202,438 | 0.307 | 660,205 | -9.66% | 0.277 | 182,876.79 |
| **Basic Automation Nonletters (piece-rated)** | **49,264** | **0.295** | **167,112** | **5.34%** | **0.311** | **51,896.68** |
| No Destination Entry | 37,715 | 0.300 | 125,716 | 5.33% | 0.316 | 39,726.26 |
| BMC Destination Entry | 11,550 | 0.279 | 41,396 | 5.38% | 0.294 | 12,170.42 |
| **3/5-digit Automation Nonletters (piece-rated)** | **23,192,500** | **0.239** | **97,096,345** | **5.47%** | **0.252** | **24,460,403.57** |
| No Destination Entry | 1,475,412 | 0.261 | 5,652,918 | 5.36% | 0.275 | 1,554,552.45 |
| BMC Destination Entry | 10,938,299 | 0.240 | 45,576,245 | 5.42% | 0.253 | 11,530,789.99 |
| SCF Destination Entry | 10,778,790 | 0.235 | 45,867,182 | 5.53% | 0.248 | 11,375,061.14 |
| **Standard Mail Enhanced Carrier Route Subclass** | | | | | | |
| **Basic Nonletters (piece-rated)** | **11,116,945.68** | **0.169** | **65,718,356** | **5.32%** | **0.178** | **11,708,467.41** |
| No Destination Entry | 107,560 | 0.195 | 552,428 | 4.77% | 0.204 | 112,695.31 |
| BMC Destination Entry | 2,162,047 | 0.173 | 12,497,369 | 5.20% | 0.182 | 2,274,521.16 |
| SCF Destination Entry | 8,818,066 | 0.168 | 52,487,892 | 5.36% | 0.177 | 9,290,356.88 |
| DDU Destination Entry | 29,272 | 0.162 | 180,667 | 5.54% | 0.171 | 30,894.06 |
| Source: CBCIS revenue and volume, Bookspan FY2004 | **34,765,586** | **0.211** | **164,378,427** | **5.32%** | **0.223** | **36,615,218** |

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS YORGEY
TO REQUEST OF PRESIDING OFFICER AT HEARINGS

During cross-examination on October 19, 2005, counsel for the OCA asked a series of questions concerning a cross-examination exhibit. Tr. 2/141-154. Subsequently, the Presiding Officer requested that I compare the exhibit with source data, examine it for accuracy, and, if needed, provide correct information with an explanation of how the corrections were developed. Tr. 2/203.

RESPONSE:

In reviewing OCA cross-examination exhibit T2 no. 1 presented during cross-examination on October 19, 2005, I have identified the miscalculations and other errors that I describe below and in two attached spreadsheets. Attachment 1 at the top reproduces the table in the OCA's exhibit; below that I present a revision of the OCA table that uses accurate data in calculations I have verified. Attachment 2 contains the revenue-per-piece calculations underlying the figures used in Attachment 1's revised table. Please note that the sole purpose of the "Revised" table is to attempt to replicate the OCA's exhibit with accurate data and calculations; the table does not represent the Postal Service's analysis.

The 18.2 cent "price" that the OCA shows as the "No rate hike,[1] no NSA" price, is, in fact, an attempt to perform an average revenue-per-piece calculation for FY 2006, and is not equivalent to the other two "prices" in the OCA exhibit. Those two figures are fixed-weight price indices calculated from a volume distribution using Bookspan's FY 2004 billing determinants, whereas the 18.2 cents represents Bookspan's average revenue per piece for FY 2005 YTD through July, thus reflecting a different (and incomplete) set of billing determinants. Comparisons of the revenue-per-piece

[1] This is the OCA's short-hand for "before rates" with regard to the pending omnibus rate case, Docket No. R2005-1.

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS YORGEY
TO REQUEST OF PRESIDING OFFICER AT HEARINGS

calculations must be made using equivalent fixed-weight indices. Using Bookspan's FY2004 billing determinants, as in the Base Year, and Bookspan's estimate of FY2006 volumes without a general rate increase, the "No rate hike, no NSA" price calculates to 18.7 cents, as shown in Attachment 2.

Additionally, the row identified as "Rate Hike, NSA" in the OCA exhibit incorrectly calculates the revenue per piece as 17.8 cents. The calculation should include the 2-cent discount on the volume between 87,000,001 and 105,000,000 pieces, not on the entire 105 million pieces for FY2006. When corrected, the FY2006 "Rate Hike, NSA" revenue per piece calculates to 19.4 cents.

"OCA Exhibit Revised" contains the revised revenue per piece, as explained above, presented in the proper, ascending order. The revenue-per-piece changes and percentage changes have been recalculated accordingly.

The OCA exhibit purported to measure the volume response to changes in prices. In order to measure such a response accurately, all things, not just the letter mail mix as represented by the billing determinants, must be held constant. Further information is needed from Bookspan in order to confirm whether witness Epp's estimates cited in the exhibit represent such a scenario of *ceteris paribus*.

**United States Postal Service**

**Institutional**

RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

OCA/USPS-T2-22. Please confirm that the report attached to this interrogatory is the one referred to in your answer to interrogatory OCA/USPS-T2-21.a.-e.

RESPONSE:

Confirmed. The report can be downloaded from:

http://www.uspsoig.gov/foia_files/MS-AR-05-001.pdf.

Office of Inspector General

August 16, 2005

STEPHEN M. KEARNEY
VICE PRESIDENT, PRICING AND CLASSIFICATION

SUBJECT: Audit Report – International Customized Mail Agreements
(Report Number MS-AR-05-001)

This report presents the results of our self-initiated, nationwide audit of the International Customized Mail (ICM) program (Project Number 04BN001MS000). The overall objective of our audit was to determine whether ICM agreements were profitable.

Although Postal Service management reported the ICM program, as a whole, had a positive contribution, opportunities exist to improve the program. Managers of the ICM program did not conduct annual reviews of individual ICM agreements to determine whether they met or exceeded their cost coverage and contribution level goals in all mail categories, or monitor individual agreements to ensure that mailers met the agreement commitments. As a result, the Postal Service did not collect payments due from guarantee clauses. These funds totaled $905,438 in additional revenue and we will report them as such in our Semiannual Report to Congress. Management revised the ICM program procedures to correct the deficiencies we identified during the audit. However, we believe management should take additional steps to improve the ICM program.

We recommended management establish the following recently implemented program changes as written policy: require annual reviews of each ICM agreement to determine cost coverage percentages and contribution levels, and require review of each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels. We also recommended management enforce the renegotiation of the postage rates and the guarantee clauses, and establish policies and procedures to ensure that annual reviews of ICM agreements are fully documented.

Management agreed with our recommendations and has initiatives planned and completed addressing the issues in this report. Management did not agree with our potential monetary benefits. Management's comments and our evaluation of these comments are included in this report.

We appreciate the cooperation and courtesies provided by your staff during the audit. If you have any questions or need additional information, please contact Robert Mitchell, Director, Marketing, or me at (703) 248-2300.

/s/ John M. Seeba

John M. Seeba
Deputy Assistant Inspector General
for Financial Operations

Attachments

cc: Anita J. Bizzotto
James P. Wade
Michael K. Plunkett
John F. Alepa
Steven R. Phelps

# TABLE OF CONTENTS

# EXECUTIVE SUMMARY

**Introduction**

This report presents the results of our self-initiated, nationwide audit of the International Customized Mail (ICM) program. Our objective was to determine whether ICM agreements were profitable.

**Results in Brief**

In fiscal year 2003, Postal Service management reported that the ICM program had an overall positive contribution of approximately $6 million. Although the overall contribution level was positive, four international mail categories had a negative contribution of approximately $12 million. Therefore, we believe opportunities exist to improve the program.

Managers of the ICM program did not conduct annual reviews of single- and multi-year individual ICM agreements to determine whether they met or exceeded their cost coverage and contribution level goals in all mail categories. By not conducting annual reviews, management was unable to identify whether individual ICM agreements, over their terms, provided a positive or a negative contribution.

Program management did not consistently monitor individual agreements in accordance with post-agreement management procedures to ensure the mailers met the agreement commitments. We identified over $905,000 in additional revenue Postal Service management could have collected—through enforcement of guarantee clauses—from mailers who did not meet their commitments. The Office of Inspector General plans to report the additional revenue in our Semiannual Report to Congress.

During our audit, management took actions to correct identified deficiencies. Specifically, management began performing annual reviews to determine cost coverage percentages for each ICM agreement, and began requiring a review of each ICM agreement on its anniversary date to determine whether mailers met their commitment levels. In addition, management eliminated ICM agreements exceeding two years.

| | |
|---|---|
| **Summary of Recommendations** | We recommended management establish the following recently implemented program changes as written policy: require annual reviews of each ICM agreement to determine cost coverage percentages and contribution levels, and require review of each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels. We also recommended management enforce ICM agreement articles allowing for renegotiation of the postage rates and guarantees, and establish policies and procedures to ensure that annual reviews of ICM agreements are fully documented. |
| **Summary of Management's Comments** | Management agreed with our recommendations and issued written policies and procedures for the ICM process in June 2005. In addition, management plans to implement the following corrective actions:<br>• Restrict all new ICM agreements to one-year terms.<br>• Review each ICM agreement on its anniversary date to determine whether mailers met their commitments.<br>• Enforce the guarantee clauses in ICM agreements.<br>In addition, management requested we eliminate all references to ICM agreement funds from this report. Management also disagreed with our potential monetary benefits. Management's comments, in their entirety, are included in Appendix C of this report. |
| **Overall Evaluation of Management's Comments** | Management's comments were responsive to our recommendations and actions planned and taken address the issues identified in the report. |

# INTRODUCTION

**Background**

International Customized Mail (ICM) agreements are contracts between the Postal Service and a mailer for a period of one or more years. These agreements provide negotiated discounts within certain categories of outbound[1] international mail. The mailer agrees to meet a prescribed annual minimum revenue or volume requirement in return for a reduced international mail rate. According to the International Mail Manual, mailers must be capable, on an annual basis, of one of the following to qualify for negotiated discounts:

- Tendering at least one million pounds of international letter-post[2] mail (excluding Global Priority Mail) or paying at least $2 million in international letter-post postage.

- Tendering at least 600 pieces of international non-letter-post mail[3] (including Global Priority Mail) or paying at least $12,000 in international non-letter-post postage.

The ICM agreement process consisted of:

- Mailer Qualification – identification of mailers who meet ICM qualifications and submission of a completed ICM application.

- Proposal Development and Approval – preparation of an ICM proposal of rates and services[4] offered by the Postal Service, joint review, [5] and final approval of the proposal to be offered to the mailer.

- Agreement Development – drafting a formal agreement for signature, based on the mailer's acceptance of the proposed terms.

[1]Outbound mail is mail departing the United States for other countries.
[2] International letter-post mail consists of letters, letter packages, publications, cards, etc.
[3]International non-letter-post mail consists of Air Parcel Post and Global Express Mail. For purposes of mailer qualification, Global Priority Mail is included in this category, although it could be considered letter-post as well.
[4]Discounts through ICM agreements can range from 2.5 to 25 percent based upon potential volume or postage commitments. Fiscal year (FY) 2003 ICM agreement discounts ranged from 12 to 15 percent.
[5]Joint review consisted of circulating ICM proposals through Marketing's Sales, International Product Development, and International Pricing, as well as Postal Service Headquarters' Legal department.

- Post-Agreement Management – monitoring mailers' compliance with agreement terms and conditions and taking corrective measures as warranted.

The Postal Service's ICM program is the responsibility of the Pricing Strategy group under Marketing's vice president for Pricing and Classification. The program was established in 1992 to identify new customers to generate contribution through customer unique pricing. The ICM program was subsequently modified to allow package mailers to also qualify for discounted pricing.

## Objective, Scope, and Methodology

The objective of our audit was to determine whether ICM agreements were profitable.[6] To accomplish our objective, we reviewed the status of 53 of 195 ICM agreements[7] with an open commitment period during FY 2003 that the Postal Service tracked in the Goldmine database system.[8] We also reviewed volume and revenue data for 49[9] of these agreements and performed a detailed historical cost coverage review of one agreement. In addition, we interviewed Postal Service Headquarters personnel in Marketing, Finance, and Information Technology, as well as field personnel in Sales. We also interviewed officials from the Postal Rate Commission (PRC). We reviewed and analyzed International Cost and Revenue Analysis (ICRA) reports; Agreement Detail Reports; the Postal Service's Purchasing Manual; and two reports issued by the PRC – Report to the Congress FY 2002 [and FY 2003] International Mail Volumes, Costs and Revenues, issued June 27, 2003, and June 30, 2004, respectively.

We conducted this audit from March 2004 through August 2005, in accordance with generally accepted government auditing standards and included such tests of internal controls as were considered necessary under the circumstances. We reviewed management controls over the ICM program related to the audit objective. Specifically,

[6]For the purposes of this report, the Office of Inspector General (OIG) defines profitability as an ICM agreement with cost coverage greater than or equal to 100 percent or contribution greater than or equal to zero.
[7]We excluded all 136 Global Package Discount agreements because the Postal Service did not individually track them by mailer and because program management eliminated these agreements from the ICM program. We also excluded six agreements that were for inbound international mail.
[8]The Goldmine database is a data warehouse used by Marketing to track ICM agreements.
[9]Four of the fifty-three agreements had not completed their commitment period at the time of sample selection and review.

we reviewed policies and procedures governing the ICM program to ensure that management met their program objectives. We discussed our observations and conclusions with management officials and included their comments where appropriate. We did not assess the reliability of the Goldmine database as part of our audit; therefore, given this limitation, we base no conclusions or recommendations solely on the data contained in the database.

**Prior Audit Coverage**

We did not identify any prior OIG audits related to the objective of this audit, although we did identify two reports issued by the PRC: Report To The Congress: The FY 2002 [and FY 2003] International Mail Volumes, Costs and Revenues, issued June 27, 2003, and June 30, 2004, respectively.

In the FY 2002 report, the PRC reported that ICM agreements were collectively responsible for more than $31.6 million in negative contributions. In response to a congressional inquiry, the Postal Service reviewed its original submission to the PRC and identified the erroneous reporting of inbound mail. The Postal Service submitted revised data, reducing the negative contributions from $31.6 million to $10 million. The Postal Service's positive contributions totaled $24 million. Overall, the contribution for ICM agreements in FY 2002 was approximately $14 million.[10]

In the FY 2003 report, the PRC reported ICM agreements had an overall positive contribution of approximately $6 million despite over $12 million in negative contribution in four mail categories.[11] The PRC also reported ICM agreements should not be cross-subsidized by domestic mailers and other (outbound) international mailers. The PRC recommended that the Postal Service continue to reassess each ICM agreement annually and include sufficient rate escalation clauses in contracts with terms longer than one year.

During our audit, ICM program management told the OIG they have taken steps to ensure the PRC is provided with

[10]The PRC and the Postal Service both used data derived from the FY 2002 International Cost and Revenue Analysis Report – PRC version.
[11]Negative mail categories in FY 2003 included economy letter packages, air letter and letter packages, air parcel post, and global direct outbound.

data showing the true financial status of ICM agreements while preserving the integrity of proprietary cost information. Specifically, program management told the OIG they had revised product categories to better fit standard product names and were in the process of developing more specific costing information directly related to ICM agreements.

## AUDIT RESULTS

Although Postal Service management reported the ICM program, as a whole, had a positive contribution for FY 2003, opportunities existed to improve the program and increase cost coverage and contribution levels. Specifically, program managers did not adequately oversee the ICM agreements by conducting annual reviews of individual agreements after they were implemented to determine whether program cost coverage goals and commitments were met. As a result, over $905,000 in additional revenue could have been collected from mailers who did not meet their commitments.

During our audit, management took actions to correct deficiencies we identified. Specifically, management began performing annual reviews to determine cost coverage percentages for each ICM agreement, and changed ICM program procedures to include a review of each ICM agreement on its anniversary date, to determine whether mailers met their commitment levels. In addition, management eliminated the use of ICM agreements exceeding two years.

We believe these changes will allow the Postal Service to more quickly identify those ICM agreements not meeting program cost coverage goals and revenue and volume commitments. This will allow management to make timely business decisions concerning the impact of individual ICM agreements on the overall contribution level of the ICM program.

### Annual Reviews Not Conducted

Managers of the ICM program did not conduct annual reviews of individual ICM agreements to determine whether they met or exceeded their cost coverage or contribution level goals in all mail categories. Management stated this occurred because they:

- Could not decide which of two ICRA reports to use to measure costs because of timing differences between the reports.[12]

[12]There are two versions of the ICRA report: a PRC version released each March and a Postal Service version released each June.

- Focused on customer retention.
- Used total revenue as the metric to measure success.

However, post-agreement management procedures required program management to monitor ICM agreements for compliance with agreed-upon terms and conditions in order to make changes when warranted.[13] By not conducting annual reviews, management did not identify whether individual ICM agreements provided a positive or a negative contribution.

We identified 53 active, outbound, non-Global Package Discount ICM agreements in FY 2003, 20 of which were 1-year agreements and 33 of which had 2 to 5-year terms. Program managers prepared cost coverage and contribution estimates during the proposal phase of the ICM agreement process, but did not review the 33 multi-year agreements after the first year to determine whether customers maintained contribution goals, even though data was available to calculate contribution and cost coverage percentages.

### Positive Contribution Not Provided in All Mail Categories

Overall, the ICM program had a positive contribution of approximately $6 million in FY 2003. However, four of seven international mail categories accounted for over $12 million in negative contributions for mail tendered under ICM agreements. See Appendix A for details.

Program managers identified deficiencies in the average unit cost calculation and informed us that one of the four categories'[14] average unit cost was not correct because it did not take into account the different weight characteristics among package types. Management further explained that the ICM agreement-specific unit cost was less than the average unit cost because the ICM agreement-specific unit cost did not include costs associated with retail operations.

[13]Postal Service personnel told the OIG that the monitoring procedures, though unwritten, were requirements under the ICM process' Post-Agreement Management phase.
[14]The mail category to which Postal Service management referred was economy–letter packages.

Although program managers identified deficiencies in the methodology used to calculate ICM agreement costs, they said the current calculation method was the only method available. Further, although ICM agreement-specific unit costs were less than the average unit costs, the four categories of international mail totaling $12 million in negative contribution indicated that not all individual ICM agreements covered their costs.

## Targeted Cost Coverage Not Always Met

During our audit, we selected one active ICM agreement with a $10 million revenue commitment for a review of historical cost coverage for the period of January 1, 2001, through December 31, 2004, to determine whether the agreement met cost coverage goals. This ICM agreement involved two international mail categories: International Priority Airmail and International Surface Air Lift Mail.

As shown in the chart below, the cost coverage percentage for International Priority Airmail declined 30 percent from FYs 2001 to 2004. Its targeted cost coverage was 120 percent.[15] Program managers attributed the decline in the cost coverage of this agreement to the combination of static postage rates and cost increases in the category of International Priority Airmail.

**Selected ICM Agreement – Cost Coverage Percentage Analysis**[16]

| | FY 2001 | FY 2002 | FY 2003 | FY 2004[17] |
|---|---|---|---|---|
| International Priority Airmail | 133% | 111% | 108% | 103% |
| International Surface Air Lift Mail | 123% | 122% | 123% | 118% |

Had management conducted annual reviews of this ICM agreement, they could have identified the lost cost coverage percentage and modified the ICM agreement.[18]

During our review of seven other ICM agreements, we identified five agreements containing a clause designed to

[15]The International Business Unit originally established an internal directive that no ICM agreement shall have an overall cost coverage below 120 percent without a compelling business case. However, the Pricing Strategy group later changed the internal directive to reflect an overall cost coverage of 110 percent to 114 percent due to rising costs and static postage rates for certain mail classes, which made the earlier goal impractical.
[16]Source: Postal Service International Pricing.
[17]Based on Goldmine data for January and February 2004, the most current data available at the time of our review.
[18]ICM agreements contain a clause designed to allow the Postal Service to modify negotiated ICM rates if costs for qualifying mail increase over 5 percent.

allow the Postal Service to raise postage rates if costs for qualifying mail increased over 5 percent. However, program managers did not exercise this clause and took no action when the qualifying mail costs increased over 5 percent. See Appendix B for additional details.

---

**Revenue and Volume Commitments Not Always Met**

Management developed ICM agreements to grow revenue and provide a positive contribution for the Postal Service. Of 49[19] active FY 2003 ICM agreements reviewed, 12 achieved revenue or volume increases above the commitment figures. However, 37 of the 49 (76 percent) did not meet their agreed-upon revenue or volume commitments. Had program managers consistently monitored individual agreements for compliance with ICM agreement clauses, program managers could have made timely business decisions resulting in over $905,000 in additional revenue during commitment periods falling within FY 2003.

Program managers stated their focus was on generating revenue rather than conducting regularly scheduled annual reviews of individual agreements to determine whether customers were on target to meet the revenue or volume terms of their agreements.

Of the 12 ICM agreements that achieved revenue or volume increases:

- Seven revenue only agreements for $89.4 million exceeded their commitments by $22.2 million, for a total of $111.6 million.

- Five volume only agreements exceeded their commitments by 22 million pieces mailed.

Of the 37 ICM agreements that did not meet agreed-upon commitments:

- Seven revenue only agreements did not meet their commitments by $17.8 million out of a total of $73 million.

- Eighteen volume only agreements did not meet their commitments by a total of 14 million pieces mailed.

---

[19]Four of the fifty-three agreements had not completed their commitment period at the time of sample selection and review. Therefore, we could not determine whether these agreements met their agreed-upon FY 2003 revenue or volume commitments.

- Twelve agreements[20] did not meet their revenue and/or volume commitments.

Five of the seven ICM agreements that did not meet revenue commitments contained guarantee clauses, enabling the Postal Service to collect an additional $905,438 as revenue in unearned discounts from mailers who did not meet the terms of their agreements. However, program managers did not exercise this clause and took no action when the mailers did not meet their commitments. See Appendix B for additional details.

**Management's Changes to the ICM Program**

During our audit, management took actions to correct identified deficiencies. Beginning in July 2004, management began performing annual cost reviews. Although program managers recorded a business case decision for each open ICM agreement, they did not always document the bases for each business case decision reached. Management also implemented ICM program procedures requiring a review of each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels. Lastly, management eliminated the use of ICM agreements with terms exceeding two years.

Although management had taken actions to identify whether individual ICM agreements would provide positive contribution to the Postal Service on an annual basis, we believe management should incorporate these recent changes into official policy.

**Recommendations**

We recommend the vice president, Pricing and Classification:

1. Incorporate into policy the recently implemented program changes to:

    - Perform an annual review of each ICM agreement to determine cost coverage percentages and contribution levels.

[20] Terms of 11 of these agreements contained an annual minimum revenue or volume requirement for which the mailer agreed to meet either one term or the other during the commitment period, while the terms for one agreement required the mailer to meet an annual minimum revenue and volume commitment.

- Review each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels.

2. Direct program managers to enforce the ICM agreement Articles allowing for renegotiation of the postage rates in ICM agreements in order to adjust postage rates affected by at least a 5 percent increase in qualifying mail costs, unless a written business case is made not to take action.

3. Direct program managers to enforce guarantee clauses to assess and collect payments from mailers not in compliance with ICM agreement terms in order to recover lost discounts, unless a written business case is made not to take action.

4. Establish policies and procedures to ensure that annual reviews of ICM agreements are documented to establish the business case for actions taken or not taken concerning cost coverage and contribution levels.

**Management's Comments**

Postal Service management agreed with all four of our recommendations and issued written policies and procedures for the ICM process in June 2005. In addition, management has restricted all new ICM agreements to one-year terms, which necessitates the annual review of rates and cost coverage, as well as adjustments for the effects of cost increases. Further, management stated it reviews each ICM agreement before its anniversary date to determine if the mailer has met the agreed-upon commitment and takes appropriate action to enforce the guarantee clauses. Finally, management requested we eliminate all references to ICM agreement from this report.

However, Postal Service management offered alternative explanations for mailers who did not meet revenue commitments in response to our draft audit report.

In response to our finding that they did not conduct annual reviews of ICM agreements, management stated they review ICM proposals and agreements annually as part of the normal vetting process. Specifically, management stated they review the customized rates for Postal Service products annually rather than review individual ICM agreements. Management added they were constantly aware of the contribution levels of the customized rates in comparison to the individual products.

In response to our finding that not all mail categories provided a positive contribution, Postal Service management stated that it appeared the negative contribution the PRC reported was due to inappropriate allocation of costs to Postal Service products with customized rates. Management further explained that the negative contribution was not a function of the customized rates themselves and that the Postal Service had corrected the cost method for data sent to the PRC, eliminating this error.

In response to our finding they did not always meet targeted cost coverage, Postal Service management never intended the cost coverage information in the executive summary – which accompanied each ICM proposal and agreement – as a target. Management also stated it took corrective action when the cost coverage declined.

In response to our finding they did not always meet revenue and volume commitments, Postal Service management stated its review process identified and enabled collection of the required penalties. Specifically, management did not agree with our monetary impact, stating that the Postal Service had either collected all postage due or determined that the commitment had been met in all categories of mail.

Management stated its position on each of the five agreements (outlined in Appendix B) where OIG claimed mailer guarantee funds were due the Postal Service, as follows:

- One agreement's volume did not include revenue from Global Bulk Economy and Global Direct-Canada Admail, which brought the total above the commitment level for the period.

- One agreement had no mail that qualified under the penalty clause.

- Three agreements were terminated prior to the expiration date, with two mailers having met their "annualized" commitments and one mailer having paid an agreed-upon amount of the penalty due based on reconciled volumes and recognized market conditions.

**Evaluation of Management's Comments**

Management's comments are responsive to the recommendations and actions planned and taken address the issues identified in the finding. However, the OIG disagrees with Postal Service management's practices for identifying and collecting lost discounts.

Specifically, the OIG disagrees with management's assessment that one agreement's revenue did not contain all mail types. Management stated this agreement, as reported, did not include revenue from Global Bulk Economy and Global Direct-Canada Admail. The OIG obtained supporting documentation from Postal Service management, which did contain these mail types.

We take exception to allowing mailers to terminate their agreements prior to their expiration dates and prorating their previously agreed-upon commitment levels by "annualizing" the mailer's annual obligation.

Mailers who agree to a higher commitment level and terminate their agreements receive deeper discounts than those mailers who commit to and meet a lower level, even though both mailers may have mailed an equal amount in revenue or volume.

# APPENDIX A
# FY 2003 REVENUE, ATTRIBUTABLE COSTS, AND CONTRIBUTIONS OF MAIL TENDERED USING ICM AGREEMENTS

| | Revenue $(000) | Attributable Costs $(000) | Contribution $(000) | Cost Coverage Percentage |
|---|---|---|---|---|
| **Economy** | | | | |
| Letter Packages | $1,765 | $8,157 | $(6,392) | 21.6% |
| International Surface Air Lift | 65,519 | 55,702 | 9,817 | 117.6% |
| **Air** | | | | |
| Letters and Letter Packages | 2,245 | 4,812 | (2,567) | 46.7% |
| International Priority Airmail | 65,788 | 57,820 | 7,968 | 113.8% |
| Express | 5,466 | 5,251 | 215 | 104.1% |
| Air Parcel Post | 3,603 | 6,732 | (3,129) | 53.5% |
| **Initiatives** | | | | |
| Global Direct Outbound | 1,064 | 1,065 | (1) | 99.9% |
| **Total** | $145,450 | $139,539 | $5,911 | 104.2% |

Source: PRC's Report to the Congress FY 2002 [and FY 2003] International Mail Volumes, Costs and Revenues, issued June 27, 2003, and June 30, 2004, respectively,with data provided by the Postal Service.

# APPENDIX B
# REVENUE COMMITMENTS NOT MET

| ICM Agreement | Revenue Commitment ($)[21] | Revenue Collected ($)[22] | Revenue Not Collected ($)[23] | Percent Revenue Not Collected (%) | Cancellation Clause[24] | Cost Renegotiation Clause[25] | Cost Increase >5%[26] | Mailer Guarantee Unearned Discount[27] | Mailer Guarantee $ Due Postal Service[28] |
|---|---|---|---|---|---|---|---|---|---|
| 1 | $10,000,000 | $5,428,155 | $4,571,845 | 45.72% | No | Yes | Yes | Yes | $336,257 |
| 2 | 1,000,000 | 35,464 | 964,536 | 96.45 | No | Yes | No | No | 0 |
| 3 | 1,000,000 | 37,233 | 962,767 | 96.28 | No | Yes | Yes | Yes | [29] 0 |
| 4 | 950,000 | 543,977 | 406,023 | 42.74 | No | No | Yes | No | 0 |
| 5 | 10,000,000 | 7,787,068 | 2,212,932 | 22.13 | Yes | Yes | Yes | Yes | [30] 299,979 |
| 6 | 10,000,000 | 8,488,419 | 1,511,581 | 15.12 | Yes | Yes | Yes | Yes | 199,728 |
| 7 | 25,000,000 | 23,343,257 | 1,656,743 | 6.63 | Yes | Yes | Yes | Yes | 69,474 |
| **TOTALS** | **$57,950,000** | **$45,663,573** | **$12,286,427** | **21.20%** | | | | | **$905,438** |

[21]Revenue commitment is the dollar amount of postage the mailer agreed to pay each calendar year during the term of the agreement.
[22]Revenue collected is the dollar amount of postage the mailer paid during the commitment period falling within FY 2003.
[23]Revenue not collected represents the difference between the revenue commitment and the revenue collected during the commitment period falling within FY 2003.
[24]A cancellation clause allows the Postal Service or the mailer to cancel the agreement with six months notice and with no penalty.
[25]A cost renegotiation clause allows the Postal Service to raise postage rates in an agreement if costs for qualifying mail increase over 5 percent during the term of the agreement.
[26]This column is to indicate whether costs for qualifying mail increased over 5 percent during FY 2003.
[27]A guarantee clause between the mailer and the Postal Service provides for the Postal Service to be reimbursed for any rate discount not earned by the mailer.
[28]This is the unearned discount the mailer should have paid during the commitment period falling within FY 2003.
[29]This mailer had no mailings applicable to the guarantee clause; therefore, no reimbursement is due the Postal Service.
[30]The mailer paid the Postal Service $220,285.39 on January 13, 2005. This leaves a remaining balance of approximately $79,694.

# APPENDIX C. MANAGEMENT'S COMMENTS

UNITED STATES
POSTAL SERVICE

April 11, 2005

KIM H. STROUD
DIRECTOR, AUDIT OPERATIONS
OFFICE OF INSPECTOR GENERAL

SUBJECT: Response to Draft Audit Report – International Customized Mail Agreement (Report Number MS-AR-05-DRAFT)

This office has reviewed the Draft Audit Report. We note that the Office of Inspector General (OIG) acknowledges that the United States Postal Service (USPS) had implemented the corrective actions suggested in the four recommendations prior to the audit. The essential OIG recommendation is that the USPS continue to enforce its standing policies and procedures regarding International Customized Mail (ICM). We agree with that recommendation.

USPS management requires that contribution levels, cost coverage, cost, volume, and revenues be treated confidentially. Therefore, appendices A and B should be removed from the final version of the report. I am enclosing a supplemental response to the Draft Audit Report which addresses issues raised in the appendices.

**Recommendation 1:**
Incorporate into policy the recently implemented program changes to:

- Perform an annual review of each ICM agreement to determine cost coverage percentages and contribution levels.
- Review each ICM agreement on its anniversary date to determine if mailers met their agreed-upon commitment levels.

**Response:**
We agree with this recommendation.

USPS management has restricted all new ICM agreements to a term of one year. This necessitates an annual review of rates and cost coverage based upon the updated attributable cost for each product. Each ICM is reviewed before its anniversary date to determine if the mailer has met the agreed-upon commitment. Any new agreement is written based upon the cost and published rates in effect at the time of renewal. If a customer has not met its commitment, a determination is made as to whether to enter into a new ICM agreement, and, if so, at what rate level.

-2 -

**Recommendation 2:**
Direct program managers to enforce the renegotiation of postage rates clause in ICM agreements in order to adjust postage rates affected by at least a five percent increase in qualifying mail costs, unless a written business case is made not to take action.

**Response:**
The Postal Service agrees with this recommendation.

All ICM agreements are reviewed a minimum of once each year to adjust for the effects of cost increases as recommended.

**Recommendation 3:**
Direct program managers to enforce guarantee clauses to assess and collect payments from mailers not in compliance with ICM agreements in order to recover lost discounts, unless a written business case is made not to take action.

**Response:**
The Postal Service agrees with this recommendation.

The USPS takes appropriate action to enforce the guarantee clauses. (See also supplemental response to appendices A & B.)

**Recommendation 4:**
Establish policies and procedures to ensure that annual reviews of ICM agreements are documented to establish the business case for actions taken or not taken concerning cost coverage and contribution levels.

**Response:**
The Postal Service agrees with this recommendation.

The USPS reviews all ICM agreements on their anniversary dates. In addition, all ICM agreements are reviewed at least once each year in light of foreign exchange rate fluctuations and updated attributable cost. Postal Qualified Wholesalers with ICM agreements including a guarantee clause are notified of their penalty obligations, if necessary, at the time of their annual review. All other ICM agreements are evaluated on their anniversary dates and are either not renewed, or renewed at rates appropriate to their actual postage or volume.

Stephen M. Kearney

Attachment

cc: Ms. Bizzotto
Mr. Phelps

**Supplemental Response to Draft Audit Report – International Customized Mail Agreement (Report Number MS-AR-05-DRAFT)**

**Annual Reviews Not Conducted**

**Targeted Cost Coverage Not Always Met**

**Response:**
Postal management was aware of the declining cost coverage caused by rising costs and static published rates. Postal management took the appropriate actions to address the situation on a system-wide basis.

The ICM program was established at a time when there were regular rate increases based on rising costs. Discounted ICM rates were tied to published rates that increased in value relative to the cost. In FY2003, the Postal Service decided, as a matter of public policy, to hold rates steady until FY2006. This event had a significant impact on the ICM program. Postal management realized that as the cost of international products rose, the contribution levels for ICM agreements decreased. In response, Postal management made four important policy decisions.

- First, Airmail Parcel Post would no longer have discounted rates except for weights up to four pounds to Japan where ICM rates were possible because of a special arrangement.
- Second, all ICM agreements would have a term of one year.
- Third, ICM rates for Global Express Mail would be determined based on a cost margin rather than a discount from published rates.
- Fourth, there would no longer be published discounts for International Priority Airmail and International Surface Airlift mail.

**Positive Contribution Not Provided In All Mail Categories**

**Response:**
The Postal Service is aware that reports to the Postal Rate Commission in prior years have not taken into account the unique characteristics of ICM mail and have underreported the true contribution of the ICM program. The Postal Service has corrected these errors in methodology. The corrected methodology demonstrates that ICM mail has a positive contribution in all categories of mail. (See attachment.)

**Revenue and Volume Commitments Not Always Met**

**Response:**
We do not agree with the assertion that there is $907,398 in revenue the Postal Service should have collected from mailers who did not meet their commitments. USPS management has either collected all postage due or determined that the commitment was met and no further postage is due.

The mailer identified as ICM agreement #1 in Appendix B with a commitment of $10 million terminated the agreement prior to the expiration date. The mailer met its annualized commitment up to the termination date and no additional postage is due the USPS.

The mailer identified as ICM agreement #3 in Appendix B with a commitment of $1 million had no mail volume to which the guarantee clause applied. No additional postage is due the USPS.

The mailer identified as ICM agreement #5 in Appendix B with a commitment of $10 million was notified of its penalty and has paid the Postal Service. No additional postage is due the USPS.

The mailer identified as ICM agreement #6 in Appendix B with a commitment of $10 million stopped mailing prior to the expiration date. The mailer met its annualized commitment up to the date of their last mailing. No additional postage is due the USPS.

For the mailer identified as ICM agreement #7 in Appendix B with a commitment of $25 million, the revenue reported in the audit does not include all revenue from all types of mail. When all revenue is included, the total exceeds the commitment. No additional postage is due the USPS.

For the mailers identified as ICM agreements #2 and #4 in Appendix B, no additional postage is due to the USPS.

All references to these funds should be eliminated from the final report.

The USPS would be pleased to review these ICM agreements and supporting documentation with the Office of Inspector General in more detail.

FISCAL YEAR 2004

| | US Origin | Non-ICMS | | | | ICMs | | | | Total Revenue | Total Contribution |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | All Countries | Rev | VVC | Cntr | % | Rev | VVC | Cntr | % | | |
| | **Economy** | | | | | | | | | | |
| 1 | Letter Packages [1] | $40 430 | $43,788 | -$3,358 | 92 | | | | | $40,430 | -$3,358 |
| 2 | Global Bulk Economy | | | | | $2,145 | $2 031 | $114 | 106 | $2 145 | $114 |
| 3 | Periodicals | $21 851 | $26,731 | -$4 880 | 82 | | | | | $21 851 | -$4 880 |
| 4 | ISAL [2] | $3,456 | $2,250 | $1,206 | 154 | $66,615 | $58,418 | $8,197 | 114 | $70,071 | $9,403 |
| 5 | Parcel Post | $80 771 | $61,982 | $18,789 | 130 | | | | | $80,771 | $18,789 |
| | Total Economy | $146 508 | $134,751 | $11 757 | 109 | $68 760 | $60,449 | $8,311 | 114 | $215,268 | $20 068 |
| | **Air** | | | | | | | | | | |
| 6 | Letters and Ltr packages | $598 009 | $377 921 | $220 088 | 158 | | | | | $598,009 | $220,088 |
| 7 | Global Direct Lettermail Canada (GDL) | | | | | $3,423 | $3 053 | $370 | 112 | $3,423 | $370 |
| 8 | Postcards | $22 044 | $13,099 | $8,945 | 168 | | | | | $22 044 | $8,945 |
| 9 | IPA [3] | $6 423 | $4,752 | $1,670 | 135 | $82,348 | $79,292 | $3,056 | 104 | $88 771 | $4,726 |
| 10 | GPM | $66 165 | $42,979 | $23,186 | 154 | | | | | $66,165 | $23,186 |
| 11 | Air Parcel Post [4, 5] | $225 381 | $197,266 | $28 163 | 114 | $4,729 | $3,413 | $1,269 | 139 | $230,110 | $29,432 |
| 12 | Express Mail [4, 5] | $164 615 | $114,938 | $49 677 | 143 | $2 505 | $2,233 | $271 | 112 | $167,120 | $49 948 |
| | Total Air | $1 082 637 | $750 955 | $331 729 | 144 | $93 005 | $87 991 | $5 014 | 106 | $1,175,642 | $336 695 |
| | Sub Total | $1,229 145 | $885 706 | $343 486 | 139 | $161 765 | $148 440 | $13,325 | 109 | $1,390,910 | $356 763 |
| | **Initiatives** | | | | | | | | | | |
| 13 | Global Direct Admail Canada (GDA) | - | - | - | - | $1,703 | $691 | $1,012 | 246 | $1,703 | $1,012 |
| | **GRAND TOTAL** | $1,229,145 | $885,706 | $343 486 | 139 | $163 468 | $149,131 | $14 337 | 110 | $1,392,613 | $357 775 |

1) Removed Global Bulk Economy (GBE) GBE is an international economy mail product with a different cost structure
2) Split ISAL between ICM and non-ICM revenue
3) Split IPA between ICM and non-ICM revenue
4) Split Air Parcel Post between ICM and non-ICM revenue
5) Redistributed the International Commercial Package revenue between Air Parcel Post and Express Mail in the ICM revenue category

Response to Draft Audit Report – International Customized Mail Agreement (Report Number MS-AR-05-DRAFT)

**Finding:**
Annual Reviews Not Conducted

**Response:**
In Postal fiscal year 2003, as part of the normal vetting process for ICM proposals and agreements, USPS management reviewed the contribution levels of its customized rates vis-à-vis the products in question on sixty one (61) separate documented occasions. Individual ICM agreements are not independent of Postal Service products. Individual ICM agreements allow customized rates for existing Postal Service products. If a given rate for a particular product provides for positive contribution, that rate provides a positive contribution each time it is applied. The contribution levels for USPS international products are calculated using the unit attributable cost of the relevant product. The contribution levels are not based on the particular cost characteristics of an individual ICM holder. USPS management was constantly aware of the contribution levels of the customized rates vis-à-vis the individual products.

**Finding:**
Positive Contribution Not Provided In All Mail Categories

**Response:**
From a review of Appendix A, it appears that negative contribution in a Postal Rate Commission report was the result of an inappropriate allocation of cost to Postal Service products for which customized rates were given. The reported negative contribution was not a function of the customized rates themselves. USPS management has corrected the costing methodology for data it sends to the Postal Rate Commission and has eliminated this error. USPS management believes this reporting error to be unrelated to the annual review of individual ICM agreements and to the actual contribution levels for customized rates. The OIG report states that it believes that although ICM agreement-specific unit costs were less than the average unit costs, not all individual ICM agreements covered their costs. However, the OIG report does not give a justification for that belief. The Postal Service further believes that the way the finding is stated unfairly ascribes negative contribution levels to ICMs.

**Finding**
Targeted Cost Coverage Not Always Met

**Response:**
The information in the executive summary which accompanies each ICM proposal and agreement was never intended to set a target. Using the most current information available at the time, the executive summary documents the fact that that the customized rates for individual products allow for positive cost coverage. Because the cost information in the executive summary is an average unit attributable cost, the cost coverage is the same for any piece of mail which is mailed at the same rate and is not volume variable. Because of the review procedures inherent in the ongoing production of executive summaries, USPS management was aware that unit cost was increasing during a period of static published rates. In direct response, USPS management took the following actions.

- First, all discounts for the Airmail Parcel Post product were discontinued except for weights up to four pounds to Japan where ICM rates were possible because of a special arrangement with Japan.

- Second, all ICM agreements were limited to a term of one year.

- Third, ICM rates for Global Express Mail were determined based on a specified markup over cost rather than a discount from published rates.

- Fourth, published discounts for International Priority Airmail and International Surface Airlift mail were eliminated

**Finding**
Revenue and Volume Commitments Not Always Met

**Response:**

It is the position of USPS management that because of its review process, the required penalties were identified and collected. The majority of ICM agreements do not provide penalties for the customer in the event that the revenue and volume commitment is not met. In those cases, USPS management reviews the actual revenue and volume at the time of renewal and makes a determination as to whether or not to renew the agreement, and, if a decision is made to renew, what customized rates to offer. Unfortunately, not all postal customers were able to fulfill their commitments for one reason or another. These reasons are not always under the control of the customer or of the USPS. Other ICM agreements do provide for penalties. The OIG report identifies five agreements containing guarantee clauses under which the USPS should have initiated action. The OIG finds that USPS management took no action when these mailers did not meet their commitment. USPS management requires that contribution levels, cost coverage, cost, volume, and revenues be treated confidentially. Therefore I am providing a supplemental response which addresses this issue.

USPS management shall provide the OIG with a written set of policies and procedures for the ICM process by July 1, 2005.

Supplemental Response to Draft Audit Report – International Customized Mail
(Report Number MS-AR-05-DRAFT)

**Revenue and Volume Commitments Not Always Met**

**Response:**

The mailer identified as ICM agreement #1 in Appendix B with a commitment of $10 million terminated the agreement prior to the expiration date. The mailer met its annualized commitment up to the termination date and no additional postage is due the USPS. The manager previously responsible for this agreement can verify that proper notification was made and the target compliance period was achieved at the time of notification, therefore no additional postage was due.

The mailer identified as ICM agreement #5 in Appendix B with a commitment of $10 million was notified of a penalty due for the compliance period extending over calendar years 2002 and 2003. The mailer ended the contract in September 2003. The Postal Service and the mailer agreed upon the amount of the penalty based upon reconciled volumes and recognized market conditions. The mailer paid the Postal Service $220,285.39 on January 13, 2005. No additional postage is due the USPS.

The mailer identified as ICM agreement #6 in Appendix B with a commitment of $10 million stopped mailing under the contract in April 2003 with a total of $4,601,127 in postage paid for the 2003 compliance period. The target for the compliance period was $3,333,333. The mailer met its annualized commitment up to the date of their last mailing and exceeded its annualized commitment by 38%. No additional postage is due the USPS.

For the mailer identified as ICM agreement #7 in Appendix B with a commitment of $25 million, the revenue referenced in the audit report did not include revenue from Global Bulk Economy (GBE) and revenue from Global Direct – Canada Admail. When these are included, the total exceeds the commitment. No additional postage is due the USPS.

All references to these funds should be eliminated from the final report.

The USPS would be pleased to review these ICM agreements and supporting documentation with the Office of Inspector General in more detail.

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

**OCA/USPS-T2-23.** Please refer to your response to the request of the Presiding Officer at the hearing on October 19, 2005. Tr. 2/203. That response, provided on October 28, 2005, included the Excel spreadsheet, "OCA_Exhibit_1.xls."

a. Please confirm that in the worksheet "OCA Exhibit," the revised "TYAR 2006 "Average Revenue per piece" (i.e., assuming implementation of the 5.4 percent rate increase, and approval of the Bookspan NSA) is $0.194. If you do not confirm, please provide the correct number, showing all calculations.

b. Please confirm that the Bookspan NSA discount of $0.02 induces new letter volume of 27 million (105 million – 78 million) in the TYAR 2006. If you do not confirm, please provide the correct number, showing all calculations.

c. Please confirm that of the 27 million new letters induced in the TYAR 2006, 9,000,001 (87,000,001 – 78,000,000) letters generate an "Average Revenue per piece" of $0.198, and revenue of $1,778,151. If you do not confirm, please provide the correct numbers, showing all calculations.

d. Please confirm that of the 27 million new letters induced in the TYAR 2006, 17,999,999 (105,000,000 – 87,000,001) letters generate an "Average Revenue per piece" of $0.178 ($0.198 – $0.02), and revenue of $3,196,301. If you do not confirm, please provide the correct numbers, showing all calculations.

e. Please confirm that the TYAR 2006 "Average Revenue per piece" (i.e., assuming implementation of the 5.4 percent rate increase, and approval of the Bookspan NSA) that induces the 27 million new letters in the TYAR 2006 is $0.184 (($1,778,151 + $3,196,301) / 27 million). (*See* Attachment OCA-2, below, for the calculation of Bookspan's Average Revenue per Piece of $0.198 in the TYBR and $0.184 in the TYAR.) If you do not confirm, please provide the correct number, showing all calculations.

f. Please confirm that Bookspan's TYAR combined elasticity of demand for its Standard Regular Mail letter-size pieces is -4.225 ((105 million – 78 million) / (78 million + 105 million)) / (($0.184 - $0.198) / ($0.198 + $0.184)). (*See* Attachment OCA-2, below, for the calculation of Bookspan's Average Revenue per Piece of $0.198 in the TYBR and $0.184 in the TYAR.) If you do not confirm, please explain and provide your estimate of Bookspan's elasticity over the range of prices from $0.184 to $0.198.

**RESPONSE:**

a. Confirmed.

b. Confirmed that there are 27 million more letters with the NSA than without it.

c. Confirmed.

d. Confirmed.

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

e. Not confirmed. A discount of two cents induces 27 million additional letters after rates.

f. Not confirmed. The own-price elasticity for Bookspan's letters is [redacted].

The elasticity of a volume with respect to any factor can only be estimated simultaneously with the elasticity of that volume with respect to all other factors that change between two states. In this case, the marginal price of letters changes, causing a corresponding change in the discount between flats and letters. As a result, the effect of the discount elasticity of flats must be taken into account in estimating the own-price elasticity of letters.

The equation form used to forecast mail volumes by witness Thress in R2005-1 can be used to derive the own-price elasticity for Bookspan's letters. The basic equation is:

$$V_t = V_b * \left(\frac{X_{1t}}{X_{1b}}\right)^{\varepsilon_1} * \left(\frac{X_{2t}}{X_{2b}}\right)^{\varepsilon_2} * \ldots * \left(\frac{X_{nt}}{X_{nb}}\right)^{\varepsilon_n} * \left(\frac{u_t}{u_b}\right) \qquad \text{(Eq. 1)}$$

(R2005-1 USPS-T-7, p. 277), where

$V_q$ is volume at time q
$X_{mq}$ are values of factors affecting volume at time q
$\varepsilon_m$ is the elasticity of volume with respect to $X_m$, and
$u_q$ is the error at time q.

Because the volumes under consideration represent different pricing scenarios, but identical time periods, all non-price factors are $\left(\frac{X_{mt}}{X_{mt}}\right)^{\varepsilon_m}$, which reduces to one, and can be ignored. For Bookspan's letters, equation 1 then becomes:

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

$$L_{NEW} = L_{OLD} * \left(\frac{P_{NEW}}{P_{OLD}}\right)^{\varepsilon_P} * \left(\frac{D_{NEW}}{D_{OLD}}\right)^{\varepsilon_D} \quad \text{(Eq. 2)}$$

where

L is the letter volume
F is the flat-size volume
P is the marginal (not average) price of letters
D is the discount of letters relative to flats
$\varepsilon_P$ is the own-price elasticity of letters, and
$\varepsilon_D$ is the elasticity of letters with respect to the discount of letters relative to flats.

From the three sets of volumes and prices, three equations can be constructed: the change between "no rates" and before-rates, "no rates" and after-rates, and before-rates and after-rates. The first two scenarios can be presented in the form of equation 2 as:

$$L_{BR} = L_{NR} * \left(\frac{P_{BR}}{P_{NR}}\right)^{\varepsilon_P} * \left(\frac{D_{BR}}{D_{NR}}\right)^{\varepsilon_D} \quad \text{(Eq. 3a)}$$

$$L_{AR} = L_{NR} * \left(\frac{P_{AR}}{P_{NR}}\right)^{\varepsilon_P} * \left(\frac{D_{AR}}{D_{NR}}\right)^{\varepsilon_D} \quad \text{(Eq. 3b)}$$

Dividing each equation by $L_{NR}$ and taking the natural log (represented here as "ln") yields:

$$\ln\left(\frac{L_{BR}}{L_{NR}}\right) = \varepsilon_P * \ln\left(\frac{P_{BR}}{P_{NR}}\right) + \varepsilon_D * \ln\left(\frac{D_{BR}}{D_{NR}}\right) \quad \text{(Eq. 4a)}$$

$$\ln\left(\frac{L_{AR}}{L_{NR}}\right) = \varepsilon_P * \ln\left(\frac{P_{AR}}{P_{NR}}\right) + \varepsilon_D * \ln\left(\frac{D_{AR}}{D_{NR}}\right) \quad \text{(Eq. 4b)}$$

Multiplying equation 4a by $\ln\left(\frac{D_{AR}}{D_{NR}}\right)$ and equation 4b by $\ln\left(\frac{D_{BR}}{D_{NR}}\right)$ gives:

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

$$\ln\left(\frac{L_{BR}}{L_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) = \varepsilon_P * \ln\left(\frac{P_{BR}}{P_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) + \varepsilon_D * \ln\left(\frac{D_{BR}}{D_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) \qquad \text{(Eq. 5a)}$$

$$\ln\left(\frac{L_{AR}}{L_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right) = \varepsilon_P * \ln\left(\frac{P_{AR}}{P_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right) + \varepsilon_D * \ln\left(\frac{D_{AR}}{D_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right) \qquad \text{(Eq. 5b)}$$

Subtracting equation 5b from equation 5a leaves:

$$\ln\left(\frac{L_{BR}}{L_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) - \ln\left(\frac{L_{AR}}{L_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right)$$

$$= \varepsilon_P * \left(\ln\left(\frac{P_{BR}}{P_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) - \ln\left(\frac{P_{AR}}{P_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right)\right) \qquad \text{(Eq. 6)}$$

Rearranging equation six results in:

$$\varepsilon_P = \frac{\ln\left(\frac{L_{BR}}{L_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) - \ln\left(\frac{L_{AR}}{L_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right)}{\ln\left(\frac{P_{BR}}{P_{NR}}\right) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) - \ln\left(\frac{P_{AR}}{P_{NR}}\right) * \ln\left(\frac{D_{BR}}{D_{NR}}\right)} \qquad \text{(Eq. 7)}$$

Finally, expanding and recombining terms in equation 7 gives:

$$\varepsilon_P = \frac{\ln(L_{NR}) * \ln\left(\frac{D_{BR}}{D_{AR}}\right) + \ln(L_{BR}) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) + \ln(L_{AR}) * \ln\left(\frac{D_{NR}}{D_{BR}}\right)}{\ln(P_{NR}) * \ln\left(\frac{D_{BR}}{D_{AR}}\right) + \ln(P_{BR}) * \ln\left(\frac{D_{AR}}{D_{NR}}\right) + \ln(P_{AR}) * \ln\left(\frac{D_{NR}}{D_{BR}}\right)} \qquad \text{(Eq. 8)}$$

Calculations are shown in the attachment to this answer.

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

**OCA/USPS-T2-24.** Please refer to the response of witness Epp to the partially redirected request of the Presiding Officer at the hearing on October 19, 2005, Tr. 2/203, provided on October 28, 2005. In his response, witness Epp states

> While a rate increase affects both letters and flats, the NSA discount only applies to letters, so in addition to the lower postage for letters (which by itself will help mail volume) flats now become more costly in relative terms which will lead to a shift from flats to letters. This shift would not be captured in any "postage-mail volume elasticity" if it existed.

a. Please confirm that witness Epp is referring to the cross-price elasticity of demand for flats with respect to the change in price of letters. If you do not confirm, please explain.

b. Where the change in letter-size volume is based on Before Rates and After Rates volumes of 78 million and 88 million, respectively, please confirm that Bookspan's TYAR 2006 own-price elasticity of demand for letters is -1.725 (((88 million – 78 million) / (78 million + 88 million)) / (($0.198 - $0.184) / ($0.184 + $0.198))). If you do not confirm, please provide the correct number and show all calculations used to derive Bookspan's TYAR 2006 own-price elasticity of demand for letters.

c. Where the change in letter-size volume is based on Before Rates and After Rates volumes of 95 million and 105 million, respectively, please confirm that Bookspan's TYAR 2006 own-price elasticity of demand for letters is -1.432 (((105 million – 95 million) / (95 million + 105 million)) / (($0.198 - $0.184) / ($0.184 + $0.198))). If you do not confirm, please provide the correct number and show all calculations used to derive Bookspan's TYAR 2006 own-price elasticity of demand for letters.

d. Where the change in flat-size volume is based on Before Rates and After Rates volumes of 78 million and 95 million, respectively, please confirm that Bookspan's TYAR 2006 cross-price elasticity of demand for flats with respect to the change in price of letters is -2.814 (((78 million – 95 million) / (78 million + 95 million)) / (($0.198 - $0.184) / ($0.184 + $0.198))). If you do not confirm, please provide the correct number and show all calculations used to derive Bookspan's TYAR 2006 cross-price elasticity of demand for flats with respect to the change in price of letters.

e. Where the change in flat-size volume is based on Before Rates and After Rates volumes of 88 million and 105 million, respectively, please confirm that Bookspan's TYAR 2006 cross-price elasticity of demand for flats with respect to the change in price of letters is -2.522 (((88 million – 105 million) / (88 million + 105 million)) / (($0.198 - $0.184) / ($0.184 + $0.198))). If you do not confirm, please provide the correct number and show all calculations used to derive Bookspan's TYAR 2006 cross-price elasticity of demand for flats with respect to the change in price of letters.

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

f. Please confirm that the average TYAR 2006 own-price elasticity of demand for letters is -1.578 ((-1.725 -1.432) / 2). If you do not confirm, please provide the correct number and show all calculations used to derive the average TYAR 2006 own-price elasticity of demand for letters.

g. Please confirm that the average TYAR 2006 cross-price elasticity of demand for flats with respect to the change in price of letters is -2.688 ((-2.844 -2.522) / 2). If you do not confirm, please provide the correct number and show all calculations used to derive the average TYAR 2006 cross-price elasticity of demand for flats with respect to the change in price of letters.

h. Please explain how the financial model for the Bookspan NSA, shown in your testimony at USPS-T-2, Appendix A, incorporated and analyzed the cross-price elasticity of demand for flats with respect to the change in price of letters.

**RESPONSE:**

a. Not confirmed. Witness Epp is referring to the discount elasticity of letters with respect to flats, that is, the price of flats less the price of letters, which measures the relative difference in the two prices.

b. Not confirmed. The own-price elasticity for Bookspan's letters is [redacted]. See OCA/USPS-T-2-23f.

c. Not confirmed. Bookspan's before-rates volume is 78 million pieces, and the own-price elasticity of Bookspan's letters is [redacted]. See OCA/USPS-T-2-23f.

d. Not confirmed. The elasticity of Bookspan's flat-size volume with respect to the discount between flats and letters is [redacted].

The equation form used to forecast mail volumes by witness Thress in R2005-1 can be used to derive the elasticity of Bookspan's flat-size volume with respect to the discount between flats and letters. The basic equation is:

$$V_t = V_b * \left(\frac{X_{1t}}{X_{1b}}\right)^{\varepsilon_1} * \left(\frac{X_{2t}}{X_{2b}}\right)^{\varepsilon_2} * \ldots * \left(\frac{X_{nt}}{X_{nb}}\right)^{\varepsilon_n} * \left(\frac{u_t}{u_b}\right) \qquad \text{(Eq. 1)}$$

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

(R2005-1 USPS-T-7, p. 277), where

$V_q$ is volume at time q
$X_{mq}$ are the values of factors affecting volume at time q
$\varepsilon_m$ is the elasticity of volume with respect to $X_m$, and
$u_q$ is the error at time q.

Because the volumes under consideration represent different pricing scenarios, but identical time periods, all non-price factors are $\left(\frac{X_{mt}}{X_{mt}}\right)^{\varepsilon_m}$, which reduces to one, and can be ignored. For Bookspan's flat-size mail, equation 1 then becomes:

$$F_{AR} = F_{BR} * \left(\frac{D_{AR}}{D_{BR}}\right)^{\varepsilon_D} \qquad \text{(Eq. 2)}$$

where

F is the flat-size volume
D is the discount of letters relative to flats
$\varepsilon_D$ is the elasticity of flats with respect to the discount of letters relative to flats.

Solving for $\varepsilon_D$ in equation 2 yields:

$$\varepsilon_D = \frac{\ln\left(\frac{F_{AR}}{F_{BR}}\right)}{\ln\left(\frac{D_{AR}}{D_{BR}}\right)} \qquad \text{(Eq. 3)}$$

See the attachment to this answer for calculations.

e. Not confirmed. Bookspan's before-rates flat-size volume is 137 million pieces, and the elasticity of Bookspan's flat-size volume with respect to the discount between flats and letters is -0.226. See part d.

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF THE OFFICE OF THE CONSUMER ADVOCATE
REDIRECTED FROM WITNESS YORGEY

f. Not confirmed. The own-price elasticity for Bookspan's letters is [redacted]. See OCA/USPS-T-2-23f.

g. Not confirmed. The elasticity of Bookspan's flat-size volume with respect to the discount between flats and letters is [redacted]. See part d.

h. The financial model did not use a cross-price elasticity for letters with respect to flats.